THE MILKEN INSTITUTE

Review

SECOND QUARTER 1999

Who Lost Brazil?

by Jeffrey Sachs

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Welcome to the second, idea-packed issue of *The Milken Institute Review*, the Milken Institute's quarterly (at least for the time being) magazine. Our goal is to inform the debate on economic policy issues, both current and future. While no one is likely to mistake MIR for *People* or *Vanity Fair*, we are going to make the hard stuff readable – and maybe even fun.

David Hale, the peripatetic chief economist at Zurich Financial Services in Chicago, stayed in one place long enough to report on the good news from Japan. Well, "good news" is putting it too strongly. Hale envisions an extended period of political infighting as Japan scrambles to halt its economy's frightening deflationary spiral. "Outsiders should not regard such conflict as unhealthy or dangerous," he says. "It is the inevitable consequence of the most far-reaching shift in Japanese economic values since 1940 – if not since the Meiji restoration."

Demographers, goes the joke, are people who wanted to become accountants when they grew up, but didn't have enough personality. **Bill Frey**, a senior fellow at the Milken Institute, may not be the ultimate party animal, but his "charticle" in this issue does prove that demographers have interesting things to say about who Americans are – and who they are becoming.

Jeffrey Sachs, the director of Harvard's Institute for International Development, was once called "the most important economist in the world" by The New York Times Magazine. I should know: I wrote the article. These days Alan Greenspan, Wim Duisenberg, Larry Summers or Eisuke Sakakibara might quibble with the choice. Still, there's no doubt that when Sachs talks, policy wonks listen.

Sachs argues (as much in anger as in sorrow) that the International Monetary Fund has let down the developing world in general, and Brazil in particular. "The principal error," he says "was to defend the exchange rate at all costs, living with high interest rates for one-and-one-half years and running down foreign exchange reserves to dangerous levels."

Cliff Winston, a senior fellow at the Brookings Institution, is best known for his analyses of airline deregulation. Like most mainstream economists, Winston assumed that free markets would serve consumers better than Soviet-style planning of routes and fares. But unlike others, he quantified what proved to be awesome gains. Yes, riding the airlines today is too much like riding on Greyhound in 1955. But more frequent service for business travelers and deep discounts for everybody else vastly outweigh the loss of comfort.

This time around, Winston tackles a more problematic issue for economists: urban transportation. While most would acknowledge that getting from here to there is a mess these days, relatively few have been prepared

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to write off America's half-century-old commitment to heavily regulated and subsidized transit. But Winston is ready to break with the past. "As long as government delivers the service and pays the bills," he writes, "urban transportation is destined to remain inefficient – and inequitable."

Marcus Noland is a specialist on Asia at the Institute for International Economics. His interests extend well beyond the usual suspects – a breadth that serves him well in this unusual contribution to MIR. Some day, some way, Noland predicts, the authoritarian, wretchedly poor North Korea will be reunified with democratic, relatively prosperous South Korea. And while no one is in a position to say how the paranoid Stalinists now running the north will play the political end-game, Germany's experience with reunification offers insights on how the two economies might be integrated. "Korea has an opportunity to learn from Germany's mistakes," he writes. "The political rights afforded to the residents of North Korea will likely prove the key determinant of economic outcomes, affecting the assignment of property rights and the extent of cross-border migration."

You may have heard of the demographic transition: the benign, seemingly inevitable decline in fertility rates, as average living standards rise. **Brad Edmondson**, the former editor of *American Demographics* (the first jazzy magazine ever on the subject), offers a chilling analysis of China's "health transition." What kills people in rich countries, it seems, is different than what kills people in poor ones – but they end up just as dead. "In the middle of the 21st century," he writes, "when today's new smokers are tomorrow's victims of lung cancer and heart disease, China can expect some three million tobacco-related deaths a year."

Those who haven't repressed all they never wanted to know about Monica, Bill and Ken may remember **Bruce Ackerman** from his testimony in the House impeachment hearings. Ackerman, a constitutional scholar at the Yale Law School, argued that the impeachment vote was effectively invalid because a new Congress was seated before the Senate got a chance to vote on the President's removal.

But Ackerman is no one-trick pony. His new book excerpted here, which is co-authored by **Anne Alstott**, (a Yale Law School colleague and former United States Treasury official), offers a bold solution to the problems of equity and social mobility in America's winner-take-all economy. "The stakeholder society is no utopia," they write. "But it does provide an alternative to our current moral drift. Perhaps we will never fully realize the American Dream of equal opportunity. But without that dream, this country will become a very ugly place."

As you might guess, **Michael Milken**, chairman of The Milken Institute, has a few ideas to share on subjects ranging from capital markets to health care. What you wouldn't be able to predict, though, is what Milken would say to an assemblage of Nobel Prize winners in economics (and vice-versa). Your curiosity is about to be slaked. We've digested his fascinating 90-minute roundtable discussion with **Gary Becker**, **Merton Miller**, **Douglass North** and **Myron Scholes** at the Milken Institute's March 1999 Global Conference into a 20-minute read.

Not enough to keep you busy? Check out the book reviews and current research abstracts, solve our acrostic puzzle or share **Mark Alan Stamaty**'s sly take on Social Security in MIR's cartoon original, Ekinomix.

– *Peter Passell* (ppassell@milken-inst.org)

P.S. Don't forget to write. Everybody likes a good letter to the editor. M

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LETTERS

WHERE CREDIT IS DUE

You observe (Michael Milken, "From the Chairman," First Quarter 1999) that balance sheets don't account for economic value. Why would they? They were designed for collateral lenders worrying about getting their money out in liquidation scenarios. But established firms rarely liquidate, so what's the sense in valuing their debt against that unlikely outcome?

It seems to me your contribution was to convince people to apply the same reasoning to new, growing firms, as in:

Firms are organic and carving them up destroys value. So it'll rarely happen, Mr. Creditor, get over it. There's no more gold standard. Instead of giving you stuff to hold against your early-stage risk, you'll get a firmer payout promise, the liquidity that comes with it and maybe an upside kicker – warrants, etc.

As firms mature, no one would dream of valuing their debt against liquidation value rather than cash flow. Maybe the ultimate example is the non-interest-bearing government debt in your pocket. What's a dollar worth, other than its pro-rata share of America's earning power?

How about writing about how your ideas would apply to emerging market restructuring? I'm no expert, but it seems that the international agency approaches have been focusing on protecting current creditors by requiring steps to pump up currency value, rather than on building the long-term value of the economies – which, after all, aren't going away.

– Mitch Berns
Washington, D.C.

OH YE OF LITTLE FAITH

In "Euroland: The Morning After" (First Quarter 1999), Lawrence Lindsey warns the United States to expect no good from the euro. He argues that the inherent flaws of the construction are such that the euro is likely to be a weak currency, and that its weakness will disrupt trans-Atlantic trade and cooperation.

Lindsey's skepticism is misguided and his view of trans-Atlantic cooperation too narrow. The creation of a monetary union by 11 continental European nations covering 250 million people is a major historical event. Only once or twice before – and never on this scale – have nations been united in monetary union other than by the force of arms.

Lindsey seems to agree with American economists like Martin Feldstein, who have argued that monetary union is such a bad idea economically for Europe that the only justification is political. In Lindsey's words, "Europe has not factored the economic ramifications into the political equation."

But the builders of the European Monetary Union (E.M.U.) did not only want to strengthen their political union, and "contain Germany." They also wanted to enhance the economic well-being of their citizens.

Paradoxically, Americans, who ought to understand this better than anyone else, often do not appreciate the push that a common currency can provide for economic integration. Monetary union will undoubtedly make capital more mobile within Europe. Cross-border investment will no longer be deterred by the complexities of accounting in different currencies and by the risk of divergent

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economic policies. Europe will move closer to the ideal of a unified business space.

This development could have profound implications for growth. It will encourage consolidation, and push European businesses to more efficient scales of operation. United States multinationals will be a part of that consolidation, as the recent wave of trans-Atlantic mergers suggests.

Furthermore, as the states of the Union compete with one another, there will be pressure for many of the Continental countries to reduce their regulatory and tax burdens. More flexibility in labor-market regulations could, over time, bring the majority of Europe's unemployed back into productive employment.

The central argument of E.M.U. skeptics in the United States has been that Europe lacks the labor mobility and the automatic stabilizing effect of Federal tax receipts to make the common currency workable. The risk is that a region deprived of the ability to devalue its way out of economic difficulties will become permanently depressed.

This is possible – which is why greater internal market flexibility is called for on the Continent. But the goods and services markets of the European Union are already so integrated that it is difficult to conceive of a sectoral problem large enough to merit devaluation that would not in fact be shared by all – and therefore would not be amenable to a currency fix in the first place.

Interestingly, the two examples of unsynchronized macroeconomic imbalance that Lindsey gives – overheating in Portugal and Ireland – could be corrected by tighter Portuguese and Irish national fiscal policy. There is nothing in the Maastricht treaty to stop a national government from running a fiscal surplus.

In my judgement, then, the economic risk is more theoretical than real, and the economic potential is substantial. Of course, it will take more than a European Central Bank to insure that these potential benefits are realized. Much will depend on how governments respond to the competitive pressures they are already feeling. If the current calls for "harmonization" (read "regulatory restrictions maintenance") prevail, a great opportunity will have been lost.

This is one of the reasons why British membership is important: Even the Labor Party will not give up Thatcher's structural gains lightly. If the competitive pressures that the E.M.U. has intensified lead to substantial deregulation, the E.M.U. will have unleashed new forces for growth.

In passing over this potential boost to the real economy, Lindsey misses an important part of the story. Instead, he analyses the construction of the European Central Bank, and points to some of its weaknesses.

In his opinion, the frailty of the European Central Bank's (E.C.B.) constitution will tend to produce a weak euro. This will permit European businesses to undercut their American competitors in a manner that will be against American interests. If the weakness goes too far, it may promote protectionism in the United States.

Lindsey then paradoxically argues that a strong euro would be against American interests, leading Europe to protectionism to ward off cheap imports. "Heads I lose. Tails I lose."

Does Lindsay simply yearn for greater trans-Atlantic currency stability? Certainly if that was a medium-term objective, the euro would help – though it is not on my short list of the main benefits of the E.M.U.

More generally, "The Morning After" raises the question of the relationship of the European construction to America's interests. Lindsey starts his essay by questioning the

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logic of United States support for European integration in the aftermath of the Cold War.

One response is that "What is good for General Motors (or Coca Cola) is good for America," and prosperity in our principal trading partners is good for American-based multinational corporations. More subtly, a politically stronger Europe is a better ally. Think also of the importance of the European Union as a beacon – eventually a haven – for the former Soviet satellites of Eastern Europe. To be able to absorb them and stabilize them, the European Union must be strong.

– Georges de Menil
Ecole des Hautes Etudes en Sciences Sociales
Senior Editor, Economic Policy, *Paris*

OH YE OF LITTLE FAITH PART 2

Like other skeptics at each stage of the process of European integration, Larry Lindsey offers many small objections to one big idea. The big idea is that Europeans can stop killing each other, competing for power and falling victim to totalitarianism by joining in a common framework for which peace, a free economy and democracy are cornerstones.

Lindsey is right that Americans should not worry that the euro will replace the dollar as a reserve currency. Experience since January really has demonstrated that to be the case. Perhaps Americans should instead think of the euro as a slightly weaker D-mark.

Lindsey is also correct that the euro's very existence will raise difficult problems of adjustment among the present 11 Euroland economies, as well as among other European nations that eventually qualify and choose to join. But, as with existing European Union institutions, monetary union is more likely to trigger changes that are more salutary than harmful.

When the Maastricht Treaty first set forth the criteria for participation, there was widespread skepticism that they could be met by more than a handful of strong-currency countries. Yet, by the deadline, 14 of the 15 members of the E.U. were able to meet the criteria for inflation rates, government debt, budget deficits and long-term interest rates. Would anyone argue that, without the discipline imposed by Maastricht, this could have happened, even as double-digit unemployment plagued Europe?

Lindsey doubts the new European Central Bank will be able to withstand political pressures toward easing, and says he is "betting on the politicians." Again, parallel arguments have been heard at each stage of the European Union's evolution from its founding. Political leaders in the big-member countries, it was feared, would always intervene to serve their own interests rather than the general E.U. interest.

There have, indeed, been some nasty episodes along the way. Yet, in the end, conflicts have been resolved and compromises made in ways that maintained the integrity of the integration process. In the case of the European Central Bank, it already seems clear that, by refusing to ease to please big-country politicians, the bank can play a positive role in furthering the structural reforms needed to insure Europe's long-term competitiveness.

It is possible, of course, that Lindsey is right and the integrationists are wrong. If that proves to be the case, United States security, as well as its economic interests will suffer, and Europe's long string of postwar successes will be broken. But as with previous tests of the integration movement, monetary union is far more likely to leave Europe stronger, freer and more prosperous than it would otherwise be.

– Ted Van Dyk
Executive Vice-President, The Milken Institute,
Santa Monica, CA

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Japan is now in the midst of a fierce recession and, by no coincidence, the most far-reaching transformation of its economic system since the Meiji Restoration in 1867. In part, the severity of the recession has resulted from the unwinding of the asset deflation – the puncturing of the real estate and stock market bubbles – of the 1980's. But the pain has been magnified by the slow pace at which Japan has been restructuring both its financial system and corporate sector. Happily, there is now a clear path to recovery.

BY DAVID HALE

Since the Second World War, Japan's economic system has best been described as "stakeholder capitalism." The corporate sector used markets to allocate resources, both human and material. It did so, though, within a framework of managed competition that tolerated cartels and minimized the role of profits in corporate decision-making.

Japanese corporations were seen as communities in which size, employment and customer relationships were all part of the bottom line. There was little pressure from shareholders to promote profitability because most corporations were controlled by cross-shareholding networks that included a main bank plus suppliers and industrial customers. In the 1980's, just one-quarter of Japanese corporate equity belonged to independent "retail" shareholders.

One consequence was a level of investment 50 to 100 percent higher than other industrial countries, financed primarily by bank lending. This investment-led system helped to produce stunning economic growth during Japan's catch-up period with the West in the first three postwar decades. But as the economy matured, it generated great inefficiencies that set the stage for stagnation in the 1990's.

DAVID HALE is the global chief economist at Zurich Financial Services in Chicago.

DESPERATE TIMES

The Japanese economy is now suffering from four related crises that are converging to force significant restructuring.

First, the banking system has close to $1 trillion worth of problem loans, the result of the collapse in asset values since the late 1980's and the recession that has more recently taken hold of the economy. The property market has lost a stunning 80 to 90 percent of its value since the peak in 1989, while the stock market has fallen by about 75 percent.

Non-performing loans, coupled with the decline in the stock market, have reduced bank capital to levels that effectively inhibit credit expansion. Where shell-shocked banks do have ample capital, they simply are not willing to take on additional risk.

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Tokyo initially denied the banking problem was serious. But by late 1998 it bowed to reality, permitting a significant injection of public money to keep the banks afloat. It also established the Financial Service Agency to regulate the banks and promote restructuring by nationalizing weak institutions or encouraging them to merge.

The agency hopes to create a consolidated system with four megabanks and four superregional banks, compared with the old system of 13 commercial banks, seven trust banks and 75 regional banks. It also intends to reduce the role of banks as shareholders in corporations.

In the old, incestuous cross-shareholding system, banks owned about 25 percent of all corporate equity, while their borrowers and friendly industrial groups controlled the great bulk of the banks' own shares. The cross-shareholding networks were thus the counterpart to a financial system in which banks provided practically all of Japan's corporate lending.

The second crisis was brought on by the collapse in corporate profitability during the 1990's. Last year the average return on equity in Japanese corporations was just 2 to 3 percent, compared with 22 percent in the United States and 15 percent in Western Europe.

Japan's high level of investment had long kept profitability below United States levels, but even in the late 1980's it was still in the 8 to 9 percent range. The economic downturn of the 1990's depressed domestic spending and created capacity gluts in key sectors, including autos, steel and consumer electronics. Compounding the problem, Japanese corporations were slow to restructure because of the country's almost ideological belief in high investment and full employment.

During the late 1980's and early 1990's, Japan typically devoted 18 to 20 percent of its gross domestic product to new plant and equipment – compared to about 10 percent in other mature industrial economies. Investment's share of G.D.P. has recently fallen to just 14 percent, but it is still too high for a country in recession.

By the same token, there is great cultural and social resistance to trimming employment. Many companies have announced voluntary retirement programs, but are reluctant to lay off workers. Since the Japanese corporate sector pays more of its compensation as annual bonuses based on revenues or output, there has been more flexibility in pay than would be possible in the United States. But still bigger cuts in compensation will be needed if the country is to avoid a large increase in unemployment.

So many companies are in trouble that unemployment has topped 4.4 percent, up from a previous postwar peak of about 2 percent. But the best guess is that Japanese corporations remain overstaffed by about 10 percent. Thus an aggressive corporate restructuring could easily double joblessness.

In the United States, a profitability crisis comparable to Japan's would set the stage for a wave of corporate mergers and asset divestitures. Japanese resistance to restructuring kept the total value of mergers and acquisitions during 1998 to just 2 percent of the rate in the United States. Still, the volume of mergers as well as foreign takeover bids has increased markedly from the past. As the corporate sector moves further to dismantle cross-shareholding, both mergers and foreign takeovers are likely to rise.

The collapse of profitability led to the third crisis, the effective insolvency of pension funds. With the pension funds' return on assets in the tank, Goldman Sachs esti-

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mates that the system's unfunded liabilities could be as large as 80 trillion yen – the equivalent of roughly $700 billion.

In 1998, Japanese insurance companies offered a return of only 2.5 percent on the retirement savings under their control, and this spring they plan to lower the rate to 1.5 percent. This crash in asset returns has forced many corporations to curtail retirement benefits to their current retirees. And the depth of the problem will soon be more visible: In two years, corporations must begin reporting unfunded pension liabilities.

Since corporations will have to inject tens of trillions of yen into the pension funds to make them solvent, a great debate has begun about how to finance the injection. The emerging consensus: transfer corporate cross-shareholdings into the pension funds. Cross-shareholdings now total about 133 trillion yen, or more than $1 trillion. So the move would do double duty, helping to untangle the cross-shareholding mess while reducing the unfunded pension liabilities.

Still to be decided is what the pension fund trustees would then do with their newly acquired equity. The funds' positions would be so heavily weighted in the bank stocks – corporations now own a lot of bank stock – that most would probably feel compelled to sell a portion. Note, too, that Japanese corporations are also turning to foreign managers to improve their asset returns, and these new managers will be even less protective of the old cross-shareholding arrangements than were the domestic ones.

The rise of pension funds in the equity market will thus have profound implications for Japanese capitalism. Pension fund trustees will have to pursue higher returns to meet their responsibilities. And this search will, in turn, compel corporate managers to change the way they do business.

TOM BLOOM (3)

By 2000, Japan's ratio of public debt to annual national output will probably exceed that of any industrial country since the Second World War.

A few companies are already giving managers incentives to respond to this challenge by introducing stock options linked to profits. But there is still deep hostility to the concept on the grounds that it promotes individual, over group, performance.

In any case, the crisis of Japan's pension funds demonstrates that corporate stakeholders' interests in profitability are far more complex than is generally understood. If corporations are to tolerate low profits in order to protect employees or suppliers, someone has to pay the piper. And with pension funds playing a larger role in allocating savings, the losers would inevitably include many retired people.

The economic slump resulting from problems in banking and corporate structure is producing a fourth crisis – this one in Government fiscal policy. Japan's public deficit will probably rise to 10 to 12 percent of G.D.P. this year, while the public debt will

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soon reach that of traditionally spendthrift countries, such as Italy and Belgium. By 2000, Japan's ratio of public debt to annual national output will probably exceed 140 percent, more than any industrial country since the Second World War.

The Government has traditionally been able to finance deficits by selling bonds to the state-controlled postal savings bank. With $2.5 trillion in assets, this institution is the largest bank in the world. It has a huge advantage in attracting household savings because it offers both insurance deposit protection and tax shelter.

Under the Japanese form of scrip, people use stamps rather than signatures to identify themselves. This permits individuals to maintain multiple identities for tax purposes. And since deposits up to 10 million yen at the postal saving banks are tax free, households often maintain more than one account. Indeed, there are 150 million accounts in a country with a total population of only 120 million.

But even the resources of the postal savings bank may be inadequate to cope with the Government's burgeoning funding requirements. The postal savings system's customers hold more than 100 trillion yen in high-yield deposits (taken out during the early 1990's, before rates fell) that will mature during the next year. Since the postal savings bank is worried that it will not be able to hold on to these deposits at the current low yields, the Ministry of Finance recently announced that the bank would purchase fewer Government bonds in 1999.

This shocked the market and caused bond yields to shoot up from 0.65 percent in the autumn to nearly 2.5 percent in early 1999. Since the Japanese bond yield last autumn was the lowest level ever recorded in human history (the previous low was 1.12 percent in Genoa during the early 17th century), it is not surprising that yields rose as the Government's funding requirement became apparent. But since Japan's inflation rate is a negative 2 to 3 percent, the upsurge in yields means that real long-term borrowing costs are now in the 3 to 5 percent range – very high for a country in deep recession. The surge in Government bond yields will, of course, also lead banks to raise interest rates on mortgages and corporate loans.

All this suggests there are limits to how far Japan can go in pursuing an expansionary fiscal policy. There have been numerous stimulus packages since 1992 focusing on both public works spending and tax cuts. These packages helped to cushion the decline in private spending. But the public debt is now reaching such high levels that it could cause bond yields to rise and thus undermine the benefits on the fiscal side.

DESPERATE MEASURES

Plainly, there is no simple way to revive an economy confronted by so many challenges simultaneously. Monetary stimulus that lowers interest rates has a limited impact on available credit because of the banking sector's problems. Low corporate profits lead households, worried about job security and pensions, to increase savings. Meanwhile, the Government's ability to spend will be increasingly constrained by the public debt and the risk it poses to long-term interest rates. The latest uptick in bond yields could also dampen capital outflows, causing the yen to appreciate and threatening export competitiveness.

The situation has become so desperate that the Bank of Japan has decided to lunge toward a highly aggressive monetary policy, lowering money market yields close to zero and expanding its purchases of short-term

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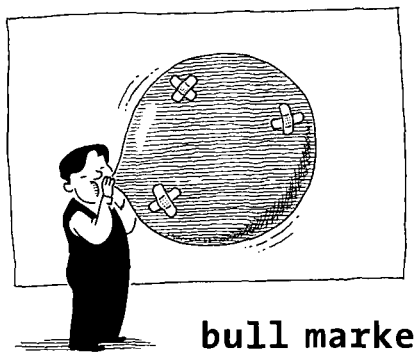
Government debt. The banking crisis will probably prevent the zero funding costs from having much impact on domestic lending, but it could encourage more global borrowing in yen.



In 1997-98 there was an impressive expansion of yen borrowing by American hedge funds to finance speculation in third-country security markets. The highly publicized near-collapse of Long Term Capital Management in September 1998 caused the banks to curtail these credit lines and set the stage for a major yen rally as the hedge funds were forced to pay back the borrowed yen. But with Japanese funding costs near zero, there is likely to be a renewal of global yen borrowing that depresses the exchange value of the currency.

The fact that the Government is simultaneously injecting trillions of yen into banks through purchases of preferred stock should also increase the odds of monetary policy becoming more effective. When America's banks had capital problems after the real estate crisis of the early 1990's, one of the ways they restored profits was to expand their holdings of Government bonds. In those days, Government bonds yielded 6 to 7 percent while the banks could attract short-term deposits at just 3 percent. And the incentives for pursuing a similar strategy today have been increased by the new global rules that make it unnecessary for banks to back Government bond holdings with their own capital.

Japanese banks may be able to pull off a similar coup, since they can now borrow for practically nothing and then stash the funds in bonds yielding about 1.5 percent. Three months ago this yield gap was less than half a percentage point.

The case for a bull market in Tokyo is increasingly compelling because of the structural changes now starting in corporations.

At both the Davos World Economic Forum and recent Group of Seven meetings, American officials appeared to signal that they could live with a weaker yen if it led to a revival of the Japanese economy. The major risk posed by yen depreciation is that it could set off speculation against other Asian currencies and provoke China to devalue the yuan. But in contrast to 1997 and early 1998, many East Asian countries have recently experienced currency appreciation because the recession has depressed their imports and led to an accumulation of foreign exchange reserves. As a result Japanese officials themselves believe that Asia could live with a yen that fell back to a trading range of 130 to 140 to the dollar, provided the depreciation occurs gradually.

What remains unclear is whether even zero interest rates will produce a large depreciation in the yen. Japan is accumulating an awesome $15 billion a month in foreign currency reserves, and commercial banks are now controlling lending to hedge funds far more carefully. Meanwhile, the monetary easing could inspire a Tokyo stock market rally and cause

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foreigners to flock back into Japanese equities on the grounds that they are finally much cheaper than Wall Street.

Despite the poor outlook for the economy in 1999, the case for a bull market in Tokyo is increasingly compelling because of the structural changes now starting in corporations. When the recession ends, Japan will not simply be a country with leaner corporations poised to bolster profitability. It will be entering a new cycle of growth in which corporate decision-making and social values will be profoundly different. There will be a new structure of corporate ownership and financial relationships – one that compels companies to focus on profits.

This new Japanese corporate sector will offer both challenges and opportunities to outsiders. It will remain a formidable competitor. But the increased emphasis on profits will lessen its tendency to compete for market share through price discounts and excessive investment.

The dismantling of cross-shareholding, along with expanded foreign ownership, will also help to open the Japanese market. Today, a hefty share of foreign trade is conducted by the subsidiaries of multinational companies operating in different parts of the world. Since foreign companies own just 1 percent of Japan's capital, compared with 10 to 20 percent in the United States and Europe, imports are lower than would otherwise be expected. The current surge in direct foreign investment in Japan will thus lessen trade tensions, which have resulted from the profound differences in the corporate structures of Japan and other industrial countries.

SEA CHANGE

In the early 1990's, Eisuke Sakakibara, the high-profile vice-minister of international finance, wrote a book arguing that Japan had produced a unique economic system – one combining a market economy with corporate behavior that transcended capitalism (the non-capitalist market economy). This system, he said, was the byproduct of corporate relationships that resulted from Japan's closed financial system and indifference to profits.

When Japan agreed to open its financial system to global competition, it set the stage for unraveling these relationships and forcing far-reaching changes in corporate behavior. As Japan is committed to more open markets and acceptance of globalization, it will now have to embrace Western ideas about economic behavior that conflict with the Sakakibara model.

While Westerners often dismiss Japan's system of hierarchy based on seniority and lifetime employment as obsolete, it does create a sense of rights and responsibilities that produces a unique corporate consciousness and code of employee behavior. Recently, for example, former executives of some of Japan's newly nationalized banks refunded the bonuses they received at retirement. They are making the sacrifice on the grounds that they should take responsibility for their imprudent management. Just imagine an American or British banker making a comparable giveback.

One obvious implication of the upheaval in Japanese business is that the Government will have to replace the implicit corporate social safety net with an explicit public one. Tokyo must raise unemployment compensation and spend more aggressively on job retraining. Japan simply cannot afford a European-style welfare state because its ratio of public debt to national income is already close to Italy's, even as retirement funding costs mushroom. But if the Japanese public is to accept the social consequences of corporate restructuring,

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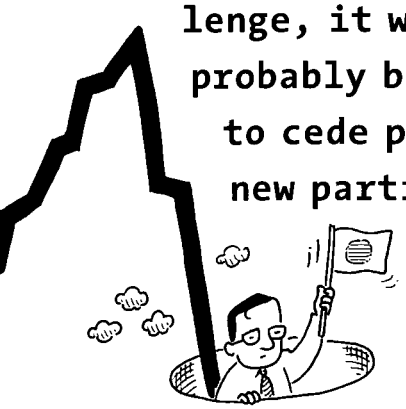
the Government will have to compensate the losers.

Nor can the Government stop with more generous jobless pay. It must also promote job creation in the service sector by accelerating deregulation and creating incentives for venture capitalists. As the United States economy has demonstrated, the best solution for replacing the jobs lost in restructuring large corporations is the rapid growth of small- and medium-sized enterprises.

Tokyo has tried to avoid restructuring by pumping cash into pork-barrel construction and by reducing interest rates to zero. But with such policy levers constrained by the public debt and the banking crisis, corporations themselves are being forced to bite the bullet. Recently, dozens of companies – most notably, Sony – have announced plans to reduce capital spending, promote voluntary retirements and divest unprofitable divisions. Some of the plans have been so momentous that share prices have rallied despite the simultaneous announcement of worse-than-expected profits.

If the Liberal Democratic Party leadership is unable to rise to the challenge, it will probably be forced to cede power to new parties.



The stock market senses that Japan has reached an economic turning point that could set the stage for a rebound in profits. But as the divergent experiences of America and Europe with restructuring will testify, the process cannot succeed in a political vacuum. The Government has yet to explicitly acknowledge the implications of restructuring. As unemployment breaches 5 percent this summer, Tokyo will have to show that it can manage the social consequences.

Japan's political system has seldom produced strong leadership in the modern era, the sort of leaders who can inspire public confidence. But with the stock market now poised to rally, the Government should have at least one economic indicator to use to persuade the public that the restructuring is essential to restoring prosperity.

If the current Liberal Democratic Party leadership is unable to rise to the challenge, it will probably suffer major losses in next year's elections and be forced to cede power to a coalition of new parties. In fact, there could be a period of political uncertainty as Japan's parties come to terms with the fundamental changes in attitude that must accompany restructuring.

Japan will doubtless make its peace with western-style capitalism eventually. But in contrast to the past, Japan is now a very comfortable society. So there could be more social conflict and political turmoil during the next few years than previously seen. But outsiders should not regard such conflict as unhealthy or dangerous. It is the inevitable consequence of the most far-reaching shift in Japanese economic values since Commodore Perry opened the nation to the West nearly 150 years ago, ushering in the modernization known as the Meiji Restoration. M

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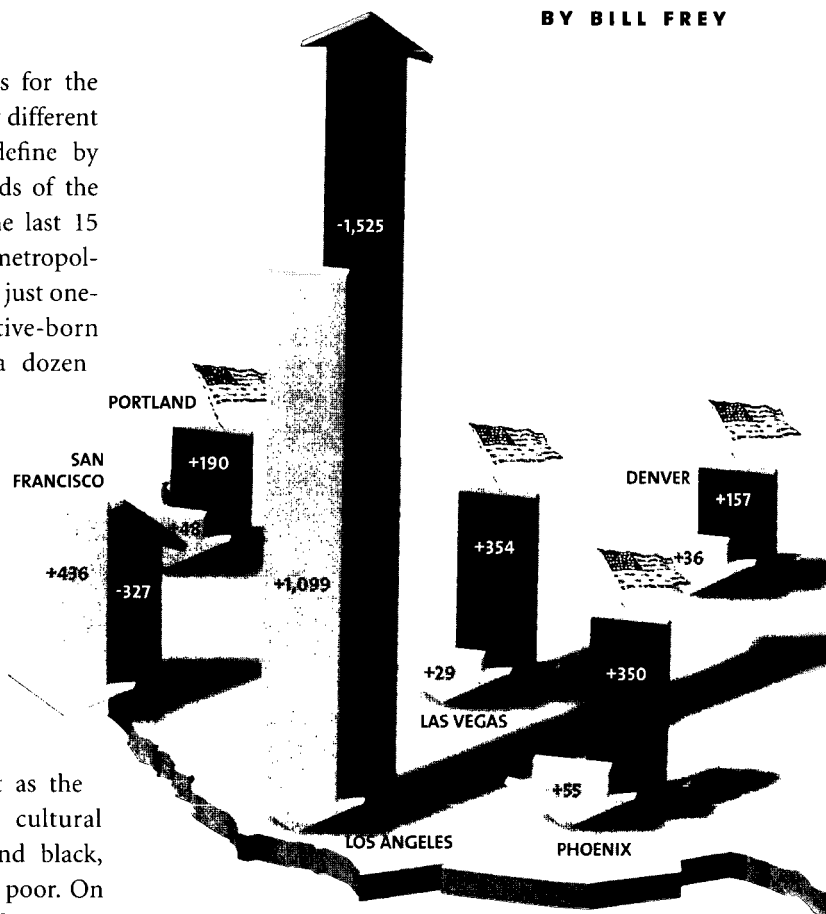
Remember the "melting pot?" Or did you go to school when "mosaic" had become the optimistic metaphor for the way the newly arrived found their geographic and social niches in a nation built by wave after wave of immigrants.

BY BILL FREY

The immigration numbers for the past few decades tell a very different story – one harder to define by metaphor. About two-thirds of the immigrants arriving in the last 15 years are now clustered in metropolitan areas that are home to just one-quarter of the native-born Americans. Meanwhile, a dozen other rapidly growing cities have become magnets of opportunity for domestic migrants, creating increasingly concentrated pockets of the older, English-as-a-first-language white and black middle-class.



This new demographic divide may, in the end, be as significant as the existing economic and cultural chasms between white and black, rural and urban, rich and poor. On the one hand, a handful of cities are fast becoming multi-ethnic caldrons – showcases for the best and worst aspects of globalism. On the other, footloose, native-born Americans in search of better jobs and housing are creating more homogeneous metro sprawls.

Still looking for a no-muss, no-fuss label? Call it Balkanization, American-style.

BILL FREY is a senior fellow at The Milken Institute.

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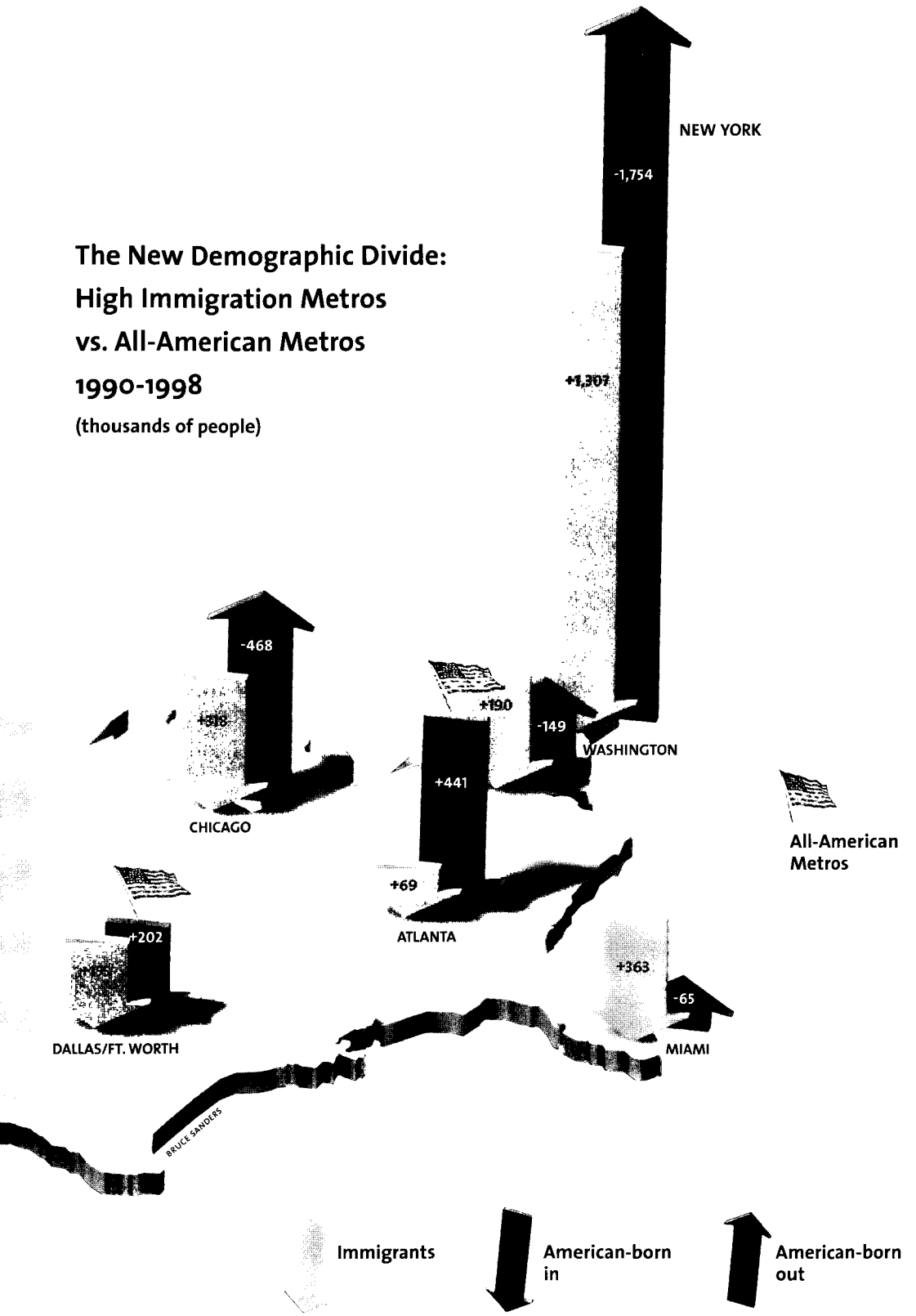
The New Demographic Divide: High Immigration Metros vs. All-American Metros 1990-1998

(thousands of people)



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Brazil

PAULO FRIDMAN/SYGMA

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Fever

First, Do No Harm.

It's sad but true: the economics profession has failed Brazil – and much of the developing world – in the 1990's.

Dozens of "emerging markets" are in chronic or acute financial crisis while economists argue endlessly – and without resolution – about what to do next. Should interest rates be raised or lowered? Exchange rates fixed or floated? Banks kept open or closed? Budget deficits reduced or raised? Even worse, the official world has anointed a single doctor, the International Monetary Fund, whose brand of medicine is decades out of date and whose principal strategy is to blame the patient for dying.

The IMF made monumental blunders in Brazil. Why isn't anybody watching the watchdog?

If economics is to be useful to the billions of people in the developing world, it will have to reconstitute its professional norms and work habits. It will have to become more like clinical medicine and less like theology.

Medicine works by linking theoretical insights to practical applications. It created institutions of peer review, case histories, post-mortems, ongoing medical education and the like – institutions to translate science into practice and practical lessons back into better science. We need a new "clinical economics" with similar methods and commitments, so that economies are no longer toyed with as objects of theoretical

By Jeffrey Sachs

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speculation or blessed by I.M.F. incantations.

First, economists need to learn to take a case history. Every country presents unique circumstances that must be understood before therapy can be adopted. Second, economists must learn the art of differential diagnosis. It's not good enough to have a theory. The real trick in clinical practice – whether medicine or economics – is to choose among a variety of competing theories about the source of particular symptoms. The I.M.F. clearly fails this step, because it believes in a single cause of macroeconomic disease: excessive budget deficits. Third, economists must learn from mistakes of failed policies.

This regimen might have saved Brazil and much of Latin America from the current crisis. Early this year the Brazilian economy went into a tailspin. The I.M.F.'s official projections as of March 1999 put the fall in Brazil's gross domestic product at 4 percent or nearly 6.5 percent in per capita terms.

The United States has not experienced such a large one-year fall in per capita income in two decades. Moreover, Brazil is not alone: the economies of Argentina, Colombia, Ecuador and Venezuela are also likely to suffer sharp contractions this year. And it's not too late (or too academic) to ask what went wrong.

To be sure, there are hints that the economy will prove more resilient than expected. but even if Brazil claws its way out of recession, the folly of the last few years offers some shocking lessons.

The crisis was predictable at least back to 1997, and really before that. Yet the malady was seriously misdiagnosed – and therefore mishandled – by the I.M.F. If there were an international court for economic malpractice, the Brazilian people case against the Washington establishment as well as their own Government.

JEFFREY SACHS is the director of Harvard's Institute for International Development.

TAKING A CASE HISTORY

Brazil has been in poor health for decades. Between 1900 and 1960, it was one of the fastest growing economies in the world. But in the 1950's and 1960's, the country's good luck ran out.

At the root of the problem was politics. With horrifying income and social inequalities – themselves rooted in centuries of slavery and in vast cultural differences between the nation's tropical and temperate zones – Brazil was unable to master the challenges of democracy, rapid population growth and explosive urbanization. The populist government was overthrown by a military coup in 1964. This was followed by a generation of political unrest and economic instability.

Brazil's generals chose a policy of economic growth at all costs, since this was seen as the ticket to political legitimacy. As a result, the military proved to be as populist-minded as the politicians it had displaced. At each crucial moment of their rule, the generals choose more public spending as a means to sustain the boom.

With a Government unable to say no, public debt mounted and inflation became more entrenched. Indeed, inflation rose from around 20 percent a year at the start of the 1970's to more than 50 percent by the end of the decade.

The generals got out while the getting was good, bequeathing an economic debacle to their democratic successors in 1985. The Government was bankrupt, inflation was rampant, and the economy was collapsing under the weight of debt, external and internal. Administrations came and went in the 1980's, trying fitfully to address the problems.

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Adding to the misery, the first democratic President-elect, Tancredo Neves, died before taking office in 1985. His replacement proved to be incompetent.

In 1990, a bright young President, Fernando Collor de Mello, offered renewed hope. But these hopes were dashed in corruption charges that forced Collor from office in 1992. The political revolving door, combined with crushing debts, led to years of chronic inflation, which finally boiled over into hyperinflation in the early 1990's.

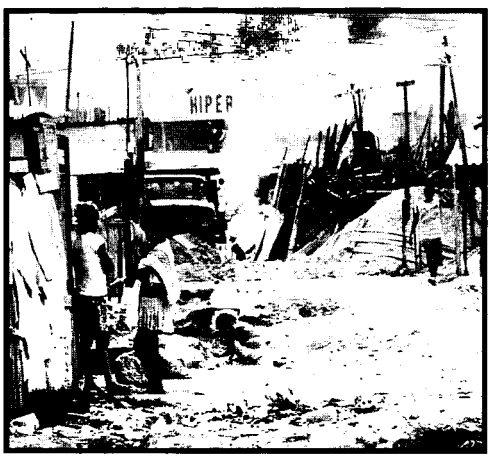
The year 1994 was a moment of truth. The mountain of foreign debt was reduced through a series of debt cancellations, while Brazil's internal debts were pared to tolerable levels by high inflation that reduced the value of outstanding Government bonds. Even the budget deficit succumbed to austerity.

Yet inflation remained rampant. And with an election looming at the end of 1994, it seemed an inauspicious time for a bold attack on the problem. Unexpectedly, Government technocrats under the leadership of Fernando Henrique Cardoso, then the Finance Minister, spotted an opening.

Brazil's high inflation, they knew, had started in the 1970's in the conventional way – as the side effect of Government profligacy. But by 1994 it had become a self-fulfilling process.

Wages would chase price increases in the previous month, in turn causing the next month of inflation. The money supply grew automatically in line with inflation since bank deposits were indexed to the price level. And the exchange rate (the price of a dollar in terms of Brazilian currency) was also adjusted routinely to keep it in line with domestic prices. Thus, wages, prices, money and the exchange rate all rose in lockstep, driven by momentum alone.

Cardoso's technocrats saw a chance to break this feedback process, to stop the futile race between wages and prices. Beginning in March 1994, they linked wages to a new index, which was effectively tied to the United States dollar rather than to the previous month's price increases. Then in July they introduced a new currency, the Real, which in turn was linked to the new index – and hence to the United States dollar at an exchange rate of roughly one to one.



JOHN CHIASSON/GAMMA-LIASON

Brazil didn't need the blood, sweat and tears of fiscal stringency to tame inflation.

With both the currency and wages linked to the dollar, a stable exchange rate meant a stable number of Reals in monthly paychecks. A stable wage, in turn, meant stable prices, so inflation melted away as part of the change in the monetary standard.

The economics team had thus discovered the magic bullet. Since inflation was largely a self-fulfilling process by 1994, Brazil didn't need the blood, sweat and tears of fiscal stringency to tame inflation. The economy merely needed to break the momentum of inflation

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by shifting to a new monetary standard linked to the dollar.

It was a pain-free stabilization, one richly rewarded at the polls. In an unusual twist the Finance Minister was elected President in a landslide – a fitting tribute for his leadership in a very clever and effective monetary reform.

Ironically, the I.M.F. had missed the boat. It had declined to back the Real Plan, claiming that the end of high inflation must, of necessity, require heavy budget cuts. After all, in the I.M.F.'s worldview, inflation is always the result of large budget deficits. The I.M.F. couldn't imagine a self-sustaining inflation, so it couldn't imagine how inflation could be stabilized without budget austerity.

By casual analysis, the I.M.F.'s pessimism about the Real Plan seemed on the mark. The budget deficit, on paper, was a whopping 52 percent of G.D.P. in 1993. But this was attributable solely to high interest rates on Government debt, needed to compensate bondholders for inflation. Once the inflation component of the interest rates was stripped out, the budget was actually in surplus. Thus, when inflation was broken in 1994, the massive budget deficit vanished. The deficit had been caused by inflation – inflation had not been caused by the deficit.

After the elections, however, the I.M.F. quickly rushed to Cardoso's side. Indeed, this affection for success later helped lead to their mutual undoing.

Cardoso's booming popularity also provided the opportunity for a thoroughgoing reform and democratization of Brazil's complex state apparatus. Problems abounded: corruption, pork-barrel politics, unconscionable inefficiencies in state enterprises. The early Cardoso administration fought and even won some valiant battles, opening Brazil's infrastructure – telecommunications, power, ports – to market forces for the first time in decades.

But the war on inefficiency was compromised by the President's need to campaign for re-election, a campaign that required a constitutional amendment and therefore votes from Brazil's patronage-hungry Congress. In the years after stabilization, the combined federal, state and local budget deficits widened to around 4 percent of G.D.P. – not a disaster, but certainly a discomfort and a warning that instability was on the horizon.

The first two years of the Cardozo administration went magnificently, with low inflation and high growth led by a consumption binge on the part of lower- and middle-class households. Public spending added froth. But problems crept into view by 1996.

The biggest problem was the exchange rate. While the Real kept its value with respect to the United States dollar, domestic wages and prices in Brazil nearly doubled between March 1994 and December 1995. The consumer boom fueled sharp increases in the prices of land and domestic services, while the price of goods subject to international competition remained fairly stable. World markets set the dollar prices of such goods, and the dollar prices translated into Real prices at a nearly stable exchange rate.

As a result, the cost of internationally traded goods declined relative to non-tradable goods, a condition that economists call a "real" (not to be confused with Real) appreciation of the currency. In 1995, the I.M.F.'s own technical staff put the real appreciation at around 35 percent.

Exporters were squeezed between rising domestic costs and stable prices for their output. This didn't worry Brazilians very much in the early years. After all, why be concerned about selling abroad when there is a

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consumption blitz at home? But the portents were serious.

Brazil is a chronically inward-looking country, one never successful for long on world markets. As of 1998, Brazil had perhaps the lowest ratio of exports to domestic output of any major country in the world – just 6 percent, a shade above the ratios in Haiti and Rwanda.

Yet export growth plays a critical role in Brazil, generating the foreign exchange needed to buy modern capital and technology from the rest of the world. Thus, the currency appreciation posed a direct threat to long-term growth. And it would soon pose an acute short-term threat to stability.

with an overvalued currency, an excessive budget deficit and waning domestic consumption. Nonetheless, the public seemed happy. Inflation was low for the first time in a generation, and the economy was moving forward.

The turning point came in the fall of 1997. Asia had succumbed to crisis in mid-1997, when foreign investors began a stampede out of Southeast Asia. Asian currencies, like the Brazilian Real, had become overvalued. Like Brazil, export performance had been weak. Like Brazil, foreign lenders had been making up the difference between imports and exports. Suddenly, with the devaluation of the Thai baht in mid-1997, they got spooked.

The rush from Asia caused investors to reassess their positions in all parts of the developing world – from Korea to Russia to Brazil. By the fall of 1997, all of these currencies were under attack. There was, of course, only one doctor on call for these sick economies, and that was the I.M.F.

The IMF's own policy of high interest rates was, ironically, directly responsible for much of the rise of the budget deficit.

The Brazilian technocrats were not oblivious to the problems of currency overvaluation. By 1996, they were depreciating the currency with respect to the dollar at a rate of around 7 percent a year. Since Brazil's inflation was still a bit above the United States rate, part of the 7 percent merely compensated for the continuing difference in inflation. A bit more compensated for the huge currency appreciation that had occurred at the start of the Real Plan. Still, the pace of currency adjustment was tiny compared with the overhang from this initial appreciation.

The torrid economic growth of 1994 (6 percent) slowed in 1995 (4 percent) and declined still further in 1996 and 1997 (3 percent). The consumption boom ebbed, but exports were not sufficiently competitive on world markets to pick up the slack. By mid-1997 Brazil seemed to be falling into a slow-growth trap,

HOW THE I.M.F. FAILED ITS PATIENTS

An economy comes to your clinic. It looks anemic. You take the pulse; growth is slowing sharply. It spikes a fever, as foreign investors flee the financial markets. What is your diagnosis? What do you prescribe?

In the not-so-distant 18th century, medical doctors had a sure response: bleed the patient. Reputable authority was quite sure of the treatment. Yet the scientific basis for the judgment was, of course, absent, and we shake our heads in amazement today at the utter uselessness of the remedy.

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But in the late 20th century, the I.M.F. doesn't perform much better. It, too, has a cure-all: cut the budget deficit (or if the budget is already in surplus, raise the surplus). So one-dimensional is the I.M.F.'s outlook that even the United States Deputy Treasury Secretary, Lawrence Summers, a major defender of the institution, jokes that I.M.F. stands for "It's Mainly Fiscal,"

In the fall of 1997, the I.M.F. had similar advice for countries stretching from Thailand to Indonesia to Korea to Russia to Brazil: cut the budget and raise interest rates, with the latter step intended to encourage foreign investors to hold on to the domestic currency.

In the first four of these countries, the I.M.F. actually lent money to encourage these actions. In the case of Brazil, the fund was merely a cheerleader, with the serious money to come only in November 1998 – after Brazil had used up most of its own foreign exchange reserves.

In both Russia and Brazil the I.M.F. urged a defense of their exchange rates at all costs, encouraging them to raise interest rates sufficiently to avoid weakening the currency. One year later, the I.M.F. recanted its early advice to cut the budgets in Thailand, Indonesia and Korea. And well it might have: G.D.P. plunged by 5 to 15 percent in these economies in 1998, in stark contrast to the I.M.F's. forecast of 2 to 3 percent growth.

The I.M.F. has not yet commented on its early advice to Russia and Brazil in the fall of 1997. But others have not been as shy. The I.M.F. simply assumed that the Brazilian budget deficit was the main source of market anxiety. Indeed, in a world in which investment bankers mindlessly parrot the words of the I.M.F., the insistence on budget cutting became part of the financial market litany.

Just as the I.M.F. had assumed that large budget deficits were behind Brazil's high inflation in 1994 (and was then proved wrong by the Real Plan), the fund assumed that large budget deficits were behind the market panics in Asia, Russia and Latin America. But something else was at work. In all of these countries (with the possible exception of Russia), two other phenomena were much more important than budget deficits.

The first was currency overvaluation. In each of these countries, exporters were getting squeezed and the markets knew it. They anticipated that policymakers would eventually allow – or be forced to allow – the exchange rate to weaken in order to restore export competitiveness.

The second was the heavy burden created by short-term borrowing abroad. Foreign banks had lent large sums to each of these countries, usually with loan maturities of one to three months. If the banks yanked their loans in anticipation of devaluation, default was likely. The countries simply lacked the foreign currency to repay their short-term debts. That fact alone made the bankers skittish and more likely to panic in a way that made default a self-fulfilling prophecy.

When the diagnosis is one thing (budget deficits) but the underlying disease is another (currency overvaluation plus excessive short-term debt), the treatment is likely not only to fail, but to fail spectacularly. In Brazil, the costs of faulty medicine are manifest today.

In October 1997, Brazil first faced the intense speculation emanating from the Asian panic. It raised interest rates to more than 50 percent and announced plans to slash the budget deficit from around 4.5 percent of G.D.P. to 2.5 percent. Growth was forecast for 3 percent in 1998. But how that was to be achieved in the teeth of astronomical interest rates, sharp budget cuts and an unchanged exchange rate policy was never explained.

Brazilian growth evaporated in 1998; in

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fact, output fell by 1.5 percent in per capita terms. The budget deficit went up to 8 percent of G.D.P. – not down, as had been programmed – and for laughably predictable reasons. High interest rates designed to defend the exchange rate fed directly into the costs of servicing the Government debt. And since Government debt in Brazil is very short term (who would trust the Government for longer?), a change in interest rates becomes embedded in nearly the entire debt within months. By 1998, interest payments on the internal debt approached 10 percent of G.D.P. And unlike the case in 1994, these interest payments were not merely a reflection of inflation, but were "real."

The I.M.F.'s own policy recommendation of high interest rates was thus, ironically, responsible for much of the rise of the budget deficit. In 1998 Brazil was chasing its own tail – and all with enthusiastic support from Washington.

Austerity in 1997 pushed Brazil into recession. In 1998, it pushed Brazil over the cliff. When Russia defaulted on its debts on Aug. 17, 1998 (its I.M.F. program collapsing within four weeks of signing), Brazil was hit again with a new wave of speculation.

Again the I.M.F. pointed to the budget deficit as the culprit and again urged Brazil to defend its exchange rate through a policy of high interest rates. As of August 1998, Brazil's central bank still had about $70 billion of foreign exchange reserves. But after several months of speculative attack, in which foreign investors cashed in their credit lines and Brazilian investors moved their money to offshore accounts, the central bank had lost approximately $45 billion of reserves.

In mid-January the Brazilian Government threw in the towel, abandoning the defense of the currency and allowing it to float. As of mid-March 1999, the Real had lost approximately 36 percent of its value vis-à-vis the dollar.

The low level of reserves ($25 billion) has left Brazil in a fragile position. Investors might still panic this year, especially in the face of the huge gap between short-term debts (perhaps $50 billion to $60 billion foreign short-term debts and as much as $250 billion worth of internal short-term debts) and meager liquid assets. Even if investors do not cut and run, they will certainly demand interest-rate premiums for holding Brazilian securities. And that will lead to a deeper recession than would have been likely a few months ago, when reserves were still around $70 billion.

Washington argued for currency stability to the bitter end, even throwing Brazil a $41 billion lifeline in November 1998. The terms of the agreement were pure I.M.F. boilerplate: use I.M.F. money to defend the currency; raise interest rates further; commit to huge fiscal cuts. This program lasted just eight weeks before it collapsed. Like the Russian plan the previous summer, it did nothing to restore market confidence, to ease the hemorrhaging of reserves or to bolster the internal political equilibrium in favor of the chosen economic policies.

When the Real collapsed in January 1999, the Brazilian team rushed back to Washington for "further instructions" from the I.M.F. They got the same package – high interest rates and budget cuts – but without a fixed exchange rate. This time, however, even the I.M.F. acknowledged that the Brazilian economy was in collapse. Its dreary November forecast (growth of minus 1 percent in 1999) had further darkened to a projected minus 4 percent as of March. In recent weeks, the Real has stabilized and Brazil is tiptoeing back into the global financial markets. But the economy is hardly out of the woods,

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and the damage caused by the futile effort to hold the line on the exchange rate will endure.

DIAGNOSING THE DIAGNOSIS

What should have been done?

The principal error was to defend the exchange rate at all costs, living with high interest rates for one and a half years and running down foreign exchange reserves to dangerous levels.

John F. Kennedy once observed that "success has a hundred fathers, while failure is an orphan." But even if nobody will accept the blame, the reasons for policy debacles are usually manifold. Before more patients are needlessly lost in the I.M.F.'s emergency room, it's worth trying to disentangle how the blunders were made.

One culprit, of course, was the Brazilian Government. As in many other countries, the economics team fell in love with the pegged exchange rate. After all, the prize for stabilizing the currency had been the presidency of Brazil. How could it be easily forsaken?

History had shown that exchange-rate-based stabilization often leads to severe real appreciation of the currency. Hence, the initial pegged rate should be followed by either a devaluation or a flexible system (as was done, for example, in Israel in the 1980's and Poland in the early 1990's). For once inflation has been wrung out of the system, a modest devaluation under non-crisis conditions will not re-ignite inflation. Brazil willfully ignored this simple lesson.

Second, Brazil's love affair with the pegged rate became embroiled in politics. Even after the Real was under attack, the Government refused to budge. Part of the reason, no doubt, was technocratic analysis: the pegged exchange rate, some argued, was best for Brazil. Another large part, however, was presidential politics.

With Cardoso's re-election looming in November 1998 and with the stability of the currency his most noted achievement, even a modest devaluation looked too chancy. As in Mexico in 1994, the painful choice of currency adjustment was put off until after elections. And as in Mexico, the collapse came in the immediate wake of the returns.

Third, Washington fell in love with Cardoso's administration and was intent on keeping him in power. Without doubt, America gave Brazil remarkable latitude to follow a course of self-destruction. United States officials plead now that it was Brazil's choice, not theirs. But it was Washington's decision to create a package of $41 billion in emergency aid, and this allowed Brazil to dig its own financial grave. The I.M.F. developed a similar crush on the Cardoso administration, with the close relationship between the deputy managing director, Stanley Fischer, and President Cardoso seemingly contributing to a loss of judgment at the fund.

One intriguing hint that personalities overruled substance can be found in the technical papers of the I.M.F. In April 1998, the organization issued a document titled "Brazil: Recent Economic Developments" (www.imf.org). It reaches the conclusion that the real appreciation of the Real cannot be ascribed to improvements in underlying productivity. In other words, the technicians argued that the currency was unambiguously overvalued, even as the I.M.F. senior management continued to back the exchange rate peg.

A fourth factor was Wall Street. With tens of billions already invested in Brazilian assets, Wall Street was ardently in favor of a bailout – and ardently against devaluation. Self-interest is, of course, a sound motivation. What's

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remarkable here is the extent to which Wall Street has called the shots for the Clinton Administration regarding the emerging markets. This is an Administration that has asked virtually nothing of the commercial banks while it has contributed around $160 billion to international bailouts.

Last are the failings of economics itself. The profession's lack of clarity with regard to emerging markets policy gives scope for brazen Brazilian politics, I.M.F. incompetence and U.S. Government myopia. Academic economists pontificate about which exchange rate system to adopt, but precious few get their hands dirty in the field.

Meanwhile, no one is there to fill the intellectual gap. Business economists are driven by the interests of their companies, not the search for truth. Investment bankers privately whispered that Brazil was foolhardy to defend the currency, while proclaiming the importance of doing just that.

WHERE TO NOW?

Brazil is in a mess this year. The human costs are enormous, though they will hardly be felt or even commented upon in the United States as long as the Dow Jones industrial average continues its miraculous ascent. The one reliable prediction is that the I.M.F. will remain in charge of the outside world's policy toward Brazil. No matter how many blunders that institution makes, it remains the lone doctor on call, thanks to the unswerving support of the U. S. Treasury. The I.M.F. will urge Brazil to keep interest rates high and to cut spending sharply. In short, it will contribute to the economic contraction.

There is no easy way out. At best, Brazil will remain on the edge of a precipice with very modest foreign reserves to keep it from going over. If international and domestic investors panic, the downturn could be closer to 10 percent of G.D.P. If investors regain confidence, the downturn might be a "mere" 2 to 3 percent of G.D.P.

To encourage the better of these bad possible outcomes, Brazil should lower interest rates, an idea the Government has taken to heart in recent weeks. It should negotiate directly with banks to keep their credit lines in place (something that seems to be happening). And it should take administrative steps to make lemonade out of some very sour lemons, using the failed currency to trigger an export boom.

No matter how many blunders the institution makes, the IMF remains the lone doctor on call.

Seen in this context, recent United States anti-dumping actions against Brazilian steel and other products are shameless and cynical manipulations of the U. S. market – steps that close off one hope for moderating Brazil's looming recession. But then again, there are few limits to the Clinton Administration's craven behavior in the face of protectionist impulses within the Democratic Party – and almost no understanding in America of how its callous actions abroad diminish the country's moral authority in the world.

We don't need a new international institution, much less a stronger I.M.F., as some have advocated. Flexible exchange rates and limits on international flows of short-term debt would have moderated or eliminated the crises that have cascaded through Latin America, Asia and Russia since 1994. But to Washington, such simple prescriptions might not be exciting enough. M

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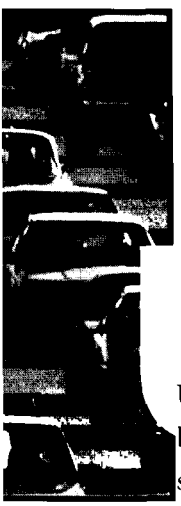

Have Car Won't Travel

The Sober – and Sobering – Case for Privatizing Urban Transportation

WWW.CORBIS.COM/ROBERT LANDAU, DOUG WILSON

By Clifford Winston

Urban transportation has become a planner's quagmire in a war that seemingly cannot be won. America's highways are jammed at rush hour, causing infuriating delays. Bus service, never fast, has deteriorated over the years, while fares have risen. Pressures to expand rail service to outlying areas remain strong, even though current rail operations cannot attract enough riders to cover more than a modest fraction of their expenses.

Popular opinion seems to be that we can – and should – spend our way out of this mess by building more roads, running more buses and installing more track. Washington agrees and, as laid out in the Transportation Equity Act for the 21st century (T21 for short), has greatly increased support for transit and highways for the 1998-2003 years. While spending more public funds for urban transportation may result in some improvements for travelers, history and serious analysis suggest that its primary effects will be to swell transportation deficits and waste tax revenues.

The grand experiment has failed. Public transportation is headed for the ashcan of history.

As long as government delivers the service and pays the bills, urban transportation is

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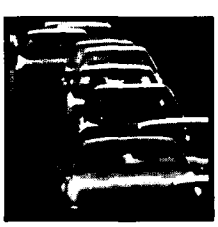
destined to remain inefficient – and inequitable. The politics that has led to excessive labor costs, bloated bureaucracies and construction-cost overruns in the past promise more of the same for the future. I am convinced that the only way to improve the system is to shield it from those influences by privatizing it.

Private operators, facing fewer operating restrictions, greater economic incentives and stronger competitive pressures, could reduce waste and make service more responsive to travelers' preferences. Moreover, they could accomplish both without funneling income from poor to rich – the little-understood reality of the current system of financing urban transportation.

To date, Federal, state and local government officials have kept urban transportation in the public sector because the political benefits they reap outweigh the political costs of fallout from the system's inefficiencies. As these costs continue to grow, however, a transition to a more efficient privatized system seems virtually inevitable. The real question is whether policy makers will stand by passively as a bad public system becomes worse, or take steps now to expedite privatization.

HOW WE GOT HERE

The Federal government began subsidizing urban transportation in the 1950's, funding urban extensions of the interstate highway system. Then, in response both to the deteriorating financial condition of private transit and to arguments by big city mayors that subsidizing transit would be more cost-effective than building highways, Congress passed legislation in the early 1960's that financed cities' acquisitions of their transit companies.



In 1974 the Federal government began providing operating subsidies as well. Growing Federal support of mass transit slowed the long-run decline in the use of buses and light rail systems – trolleys and streetcars. By the late 1970's, Federal subsidies had expanded bus and heavy rail capacity. Capacity has continued to increase in the last two decades, yet other trends revealed ominous weaknesses in service.

Many cities have cut bus service frequency on their core routes in order to extend service to the suburbs. Meanwhile, cities including New York, Chicago and San Francisco have cut rail-service frequency and raised real (inflation-adjusted) fares. Indeed, since 1980 real transit fares have increased 44 percent. Although Federal support of public transit was intended to lure urban travelers from their cars, the share of commuters who use bus and rail has diminished since the 1960's. Rising incomes and suburban sprawl have reinforced commuters' preferences for their automobiles, causing autos' share of work trips to climb to nearly 84 percent by 1990. Between 1960 and 1990, mass transit's share of all trips in large urban areas fell from more than 20 percent to less than 10 percent.

Transit's long-run growth in capacity and decline in patronage have combined to create deficits that are a serious drain on the public purse. By 1995, public transit operating expenses in the United States were about $18 billion a year, almost twice the yearly $9.6 billion in operating revenues. Continuing capital investments are swelling this deficit. And sadly, most of the subsidies do not benefit travelers. According to Don Pickrell (1985) and Douglass B. Lee (1987), as much as 75 percent of Federal spending on mass transit ends up in the pockets of transit workers (as above-market wages) or to suppliers

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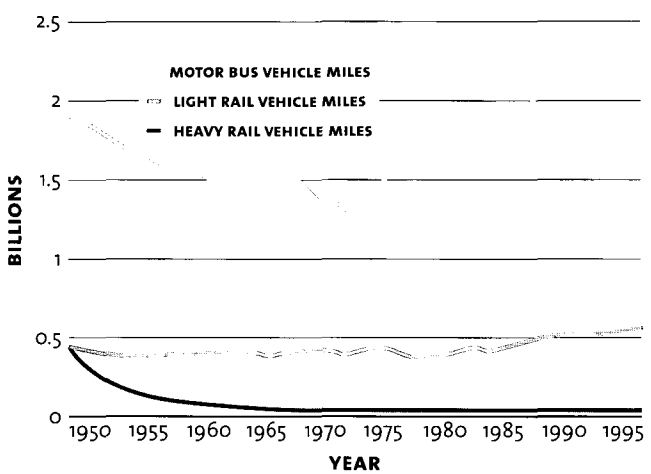
of transit capital (as higher profits and interest). Just 25 percent is used to improve service and lower fares.

With many cities planning to build new light rail systems or extend existing ones, transit deficits are certain to keep growing. Indeed, if experience is any guide, rail ridership will be grossly overestimated at the planning stage for new service, while capital and operating costs will be underestimated.

MASS TRANSIT MODES



The tendency for urban rail to expand also makes it difficult to forecast how much a system will cost when the network is completed. For example, projected costs of the proposed light rail and subway lines in Los Angeles have continued to escalate, as plans have become more ambitious. Los Angeles county voters were so put off by the most recent cost projection – $75 billion over the next 20 years – that they voted to prohibit the use of local sales-taxes to continue construction.

Signs of a backlash do not seem to have much effect on the chattering classes, though. A recent New York Times editorial chided state and city officials for their lukewarm response to the Regional Association's plan for a $13 billion expansion of New York City's subway. Meanwhile, proposals for constructing and extending other urban rail systems throughout the country continue to move forward.

With its share of trips now at 90 percent, the automobile is more than ever the dominant form of urban transit in America. But having invested hundreds of billions of dollars building and maintaining roads to accommodate autos, the public has begun to lose patience with road construction that never catches up with demand. For example, after an eight-year marathon of construction to widen parts of Interstate 270 in suburban Washington, D.C. to 12 lanes, traffic already exceeds levels projected for 2010.

Workplace and residential relocations during the 1990's – largely the result of the trend toward working and living in distant suburbs – have helped to stabilize congestion. But estimates of the ongoing costs of congestion, mainly in the form of wasted time but also in wasted fuel and vehicle wear and tear, run as high as $40 billion a year.

All this suggests that we are not likely to improve urban transportation much by throwing gigabucks at the problem. We could, however, make much more efficient use of the resources devoted to urban transportation. First, prices of all modes could be more closely aligned to costs, reducing the incentives to use too much or too little of each. Second,

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transit and highway services could be adjusted to maximize the difference between benefits and costs after properly accounting for "externalities" such as pollution and congestion. Finally, travelers could signal more effectively the services for which they are willing to pay, and suppliers could be given greater incentives and freedom to provide them efficiently.

Although transit policy makers are not likely to reshape the public system in these ways, a reformed public sector is not the only possible solution. If a substantial portion of the urban transportation system were privatized, I am convinced that market forces could manage what public officials are unable or unwilling to do.

A TAXONOMY OF WASTE

Public mass transit deficits exist because policy makers set prices and service levels that generate less revenue than is warranted for the service provided. Likewise, severe highway congestion is caused by pricing that makes auto travel less costly to the individual driver than its impact on other drivers would warrant.

What are the social costs of these inefficient policies? Chad Shirley and I have estimated the impact on travelers and taxpayers of a policy that fully charged travelers for the costs of their trips, and provided additional service only to the point where the added benefits equaled the added costs. In the case of autos, cost-based pricing could be implemented by setting highway tolls that vary with the level of congestion. Current technology can assess such tolls without disrupting motorists' journeys or invading their privacy.

The net benefits (added benefits less added costs) from implementing only the pricing component of this policy total nearly $8 billion a year. Because optimal pricing means much higher fares and tolls, travelers lose $16 billion. But these private losses are more than offset by the reduced public transit deficits and accumulated toll revenues that bring the urban transportation budget into balance.

It's not clear, of course, that the average citizen is likely to see benefits in policies that increase his own costs, even as they lower public deficits. But studies have found that voters are more inclined to support elected officials who reduce government spending. It's thus likely that travelers wearing their hats as taxpayers would vote for their enlightened self-interest at the ballot box.

Cost-based urban transit punctures some sturdy truisms. Transit subsidies have long been justified on grounds of efficiency because auto travel is implicitly subsidized – that is, a traveler's costs of using his or her-

EFFICIENT COMMUTER PRICING AND SERVICE: WHO WINS, WHO LOSES

BILLIONS OF 1998 DOLLARS

ASSUMPTION AND MODE	CONSUMER BENEFITS	GOVERNMENT BALANCES	NET BENEFITS
EFFICIENT PRICING ONLY			
AUTO, BUS AND RAIL TOTAL	**-16.0**	**23.9**	**7.9**
Auto toll	-8.2	12.0	3.8
Bus	-4.3	7.0	2.6
Rail	-2.4	2.8	0.4
NET - BENEFIT MAXIMIZATION EFFICIENT PRICING AND SERVICE FREQUENCY			
AUTO, BUS AND RAIL TOTAL	**-16.2**	**29.3**	**13.0**
Bus	-4.3	11.7	7.3
Rail	-2.8	4.3	1.6

SOURCE: Shirley and Winston (1998)

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automobile do not include the costs of added congestion, pollution and the like. Our findings show, however, that overall urban transportation efficiency would improve if any mode's prices were more closely aligned with its costs. Current fares are so out of line with costs that pricing transit according to cost would reduce economic waste, even if the price of using cars remained unchanged. By the same token, raising the cost of driving without raising mass transit fares would also increase overall transit efficiency.

Net benefits to society would climb to a whopping $13 billion a year if service frequency as well as prices were adjusted to maximize net benefits. Current transit frequency is excessive because of low ridership. Thus cutting frequency generates benefits because public deficits are reduced by more than the value of the service lost to urban travelers.

Another popular theory is that transit should be subsidized because auto travelers do not pay the costs to society of accidents and pollution. Shirley and I do find that the net benefits would be even greater if we fully accounted for the policy's effect on accidents and pollution – but not because auto travel would be reduced. Efficient pricing and service would increase auto travel and accident costs, but the lower accident costs from less bus and rail travel would offset these costs. Similarly, pollution costs increase because of more auto travel, but decrease because of reduced travel by buses.

Additional inefficiencies in the public sector arise because rail and bus companies do not minimize the cost of producing a given level of service – as the high proportion of empty transit seats attests. During the mid-1990's rail filled roughly 18 percent of its seats with paying customers, while bus filled roughly 14 percent. In contrast, about one-third of auto's carrying capacity is typically filled. These differences in capacity utilization have clear implications for mass transit's cost competitiveness with autos. While transit's average operating costs per seat mile are lower than auto's, this potential cost advantage is never realized in practice because empty seats drive its operating costs per passenger mile much higher than auto's.

Government officials have kept urban transportation in the public sector because the political benefits outweigh the fallout from the system's inefficiencies.

Nor is automobile travel on urban thoroughfares produced at minimum cost. According to Gabriel Roth (1996), highways make inefficient use of their capacity and actually cost government more than is collected in fuel taxes when depreciation of highway capital is taken into account. Kenneth Small, Carol Evans and I (1989) also found that highway pavement is generally too thin, which raises maintenance costs. The bottom line: Improved capacity use and road durability could greatly lower the costs of urban auto travel.

Until analysts get a better handle on the potential of both mass transit and auto travel, it is premature to say whether the most

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efficient urban transportation system would shift travelers from mass transit to auto, or vice-versa. It is already clear, however, that the delivery of urban transportation by government is creating substantial inefficiencies from travel by all modes.

THE POLITICS OF URBAN TRANSPORTATION

It's no secret why government can't cope with transit inefficiencies: Policy makers (appropriately) respond more to political forces rather than market forces. Although government subsidies largely accrue to transit managers and suppliers of transit labor and capital in the form of higher wages, profits and interest payments, a portion does go to the popular causes of keeping fares below cost and expanding service beyond the level that could be supported without subsidies. Probably more important, these public benefits are enjoyed by groups with influence disproportionate to their numbers – high-income commuters, business developers and so on.

Shirley and I estimate that more than 80 percent of the waste from sub-optimal urban transit fares and frequencies can be attributed to these political influences. Transit inefficiencies might be more easily overlooked if they redistributed income from the well-to-do to the poor, but this is not the case. Everyone gets something from the grab bag: transit managers and workers get higher wages, while lower- and middle-income bus riders get more frequent service. Upper middle-income rail riders cash-in through more frequent service and greater route coverage.

With the average annual household income of bus commuters approaching $40,000 and the average annual household income of rail commuters exceeding $50,000, the poor are hardly transit's greatest beneficiaries. Indeed, since the tax burden created by transit subsidies takes a larger portion of income from the poor than from the rich, it is clear that public transit is increasing – not decreasing – inequality.

The recent failure to impose variable tolls reflecting congestion costs on the San Francisco Bay Bridge, as described by Stephen Shmanske (1996), illustrates how politics drives highway transportation. Congestion-linked tolls were to be part of a Congressionally approved demonstration project, but the Metropolitan Transportation Commission and the California Department of Transportation decided to commit a share of the toll revenue to various public agencies overseeing alternative transit modes. The California legislature subsequently rejected the tolls on the grounds that they amounted to a tax increase designed to funnel money to bureaucratic, loss-making transit systems.

BIG CITY COMMUTERS

HOW THEY COMMUTE	1960	1970	1980	1990
MILLIONS OF WORKERS				
Privately Owned Vehicle	17.5	27.6	36.5	49.8
Bus	3.8	3.3	3.0	2.9
Subway/Rail	2.3	2.2	2.0	2.3
Walk	3.0	2.7	2.1	2.2
Other	2.2	1.2	1.7	2.4
PERCENT OF WORKERS				
Privately Owned Vehicle	61.0	74.4	80.4	83.5
Bus	13.1	9.0	6.7	4.9
Subway/Rail	8.0	5.9	4.5	3.8
Walk	10.4	7.4	4.7	3.8
Other	7.5	3.3	3.7	4.0

SOURCE: Federal Highway Administration

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HAVE CAR WON'T TRAVEL

Thus the country's only approved congestion-pricing demonstration was never implemented.

Urban transportation inefficiencies are not a "mistake" that can be easily corrected: entrenched political forces make it difficult for the public system to be improved. Unfortunately, increased Federal support for transit and highways will only delay the search for an alternative.

THE CASE FOR PRIVATIZATION

You don't need to be a libertarian to conclude privatization represents the only realistic hope for paring the huge inefficiencies that have developed in all modes of transportation under public management.

fall at least a third because private bus and rail companies would reduce labor and capital costs by using the latest technologies to improve routing, scheduling and vehicle design. Improved customer service would fill more bus and rail seats, lowering costs per passenger still further. Costs would also fall because a competitive (and unsubsidized) transit market would force companies to reduce transit wages. The typical Washington Metrobus driver, for example, gets paid as much as 50 percent more than drivers for the handful of private bus companies operating in the D.C. area.

Competition among conventional bus, rail, taxis and autos, along with new entrants such as jitneys and minibuses, would insure that cost reductions become fare reductions. New

Travelers wearing their hats as taxpayers would vote for their enlightened self-interest at the ballot box.

Just how would privatization make a difference? Private bus and rail companies, competing vigorously with each other and with private autos, would set prices and service to maximize profits. Shirley and I found that the economic effects of such competition are remarkably similar to the effects of efficient pricing and service. Society's gains from eliminating transit deficits – private carriers would earn profits – would substantially exceed travelers' losses from higher fares and reduced service.

These findings, however, focus only on pricing and service inefficiencies. They far overstate the potential losses to travelers because they do not reflect the improvements in operating efficiency that could be achieved by private carriers. Transit costs are likely to

entrants are likely to be an especially important source of competition. Many travelers in New York City, for example, prefer the service offered by illegal gypsy vans to that of public transit. Urban travelers would play an important role in spurring efficiency by adjusting their travel plans and (in the case of corporate buyers) developing bargaining power with carriers – much as inter-city travelers and shippers have done in deregulated air, rail and trucking markets.

Most likely, though, the private market's primary benefit to travelers would be more innovative and responsive services. By using new technologies – personal rapid transit and real-time, demand-responsive services, for example – that are currently suppressed in the public system, carriers could provide more

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convenient and reliable service. Private carriers would also have an incentive to adjust their routes in accordance with economic and demographic changes. The current public system has been largely unresponsive to such changes, failing, for example, to expand service from the inner cities to suburban areas with growing demand for workers.

OBJECTIONS TO PRIVATIZING TRANSIT

Some opponents of privatization argue that it simply will not work, noting that the Federal government got involved in urban transit during the 1960's precisely because private transit failed. Peter Pashigian (1976) and George Hilton (1985) point out, however, that the lesson of private transit failure is more complicated. The collapse of private bus companies was largely due to regulation – that is, regulation that seriously hampered performance.

Other critics point to the more recent British experience with privatizing buses. Peter White's (1995) characterization of Britain's experiment thus far parallels the predictions for the short-term consequences of transit privatization in the United States. Public subsidies have fallen along with costs. Fares have risen, minibuses have emerged as a major form of service innovation and bus ridership has generally declined in response to higher fares. Longer-run developments are as yet uncertain.

My view is that the 1950's United States experience and recent British experience with private transit are of little relevance to contemporary America. A more useful perspective comes from the consequences of railroad deregulation in America in the 1980's. Although policy makers were aware that regulation inflated the costs of rail operations, they were concerned that railroads' monopoly power in some regions would allow them to raise shippers' rates.

In fact, the deregulated railroads have reduced their costs, while fierce competition among railroads and trucks has cut average rates by more than 50 percent. Service quality has substantially improved, and the industry is more profitable than it would have been under regulation. Critics of deregulation and privatization, I would argue, both underestimate the intensity of competition and overestimate the extent to which specific groups of consumers are likely to be hurt.

RON CHAPPLE/FPG

What's wrong with this picture?

Another objection to privatization is that its benefits would be achieved only by redistributing income from low- or fixed-income travelers to wealthier citizens. The implication

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is that the poor and elderly are currently the primary beneficiaries of public transit. In fact, the opposite seems to be true.

Where transit systems are creating new routes, they mainly focus on well-heeled commuting professionals heading toward the central business district. And this expanded service is typically financed by taxes that fall disproportionately on the poor. As I noted above, public transit has failed to connect lower-income inner-city residents with new jobs in the suburbs. By the same token, Richard Crepeau and Charles Lave (1996) have found that the mobility of the elderly depends little on public transit.

Area Rapid Transit (BART) system in San Francisco, for example, are paid more than $40,000 a year. The economic effects of privatization on the transit labor force, however, are not entirely clear. Although it is likely that wages would fall, an efficient private transit industry could actually increase patronage and total transit employment.

In view of the sound case for privatization and the weakness of the objections to it, Washington should begin what is sure to be a long transition by encouraging cities to run privatization experiments. Federal grants could be used to encourage such experiments. Cities should also be given the flexibility to find their own way to introduce private competition in transit and to reduce transit's dependence on taxpayers.

Since the tax burden created by transit subsidies takes a larger portion of income from the poor than from the rich, public transit is increasing – not decreasing – inequality.

A compelling example of the potential benefits of privatization for low-income workers is new dollar-a-ride service in the New York City borough of Queens. Queens Van Plan, a private company serving mostly low- to middle-income minority workers whose neighborhoods are neglected by public mass transit, provides an indispensable service and operates at a profit. However, current regulations prevent the company from serving other low-income areas of New York. Under a privatized system, Queens Van Plan and similar entrants would be free to expand where the market demanded.

Transit union leaders resist efforts to privatize transit because they wish to protect the high wages and job security of their members. Train operators and station agents for the Bay

Of course, it would take time for businesses and travelers to adjust to the new competitive order. While privatization is unlikely to cost low-income travelers more in the long run, short-term assurances – perhaps in the form of a transportation voucher program – would build support for the experiments. Once experiments begin, however, policy makers must allow competitive markets to evolve and not micromanage the transition.

PRIVATE ROADS

The costs of road transportation in the United States are inflated because pavements are too thin and road capacity is inefficiently used – jammed during peak travel hours and

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lightly traveled at other times. The source of these problems, economists widely agree, is inefficient pricing, investment and maintenance. As in the case of transit, these inefficiencies are likely to be reduced only if roads are subjected to competitive forces. But is such competition feasible?

New Zealand is considering giving government roads to commercial road companies, which would be expected to charge for their use and earn a return on capital while being regulated as public utilities. I hesitate to recommend this step for America, however, because regulators would very likely micromanage tolls and thus discourage efficient pricing schemes.

The argument for commercialization, and eventually privatization, may become more compelling as road technology evolves. Many transportation engineers and planners envision highways where sophisticated navigational aids guide choices of routes, set travel speeds and even drive the vehicles. These technological advances call for much greater management of highway travel, which in turn could generate inefficiencies that prompt calls for a private road traffic control system – much as it has with air traffic control. If the Federal government wants to move to a new era of highway transportation, it should give serious thought to allowing private companies to manage the road system.

WHAT WILL SPUR CHANGE?

Since policy makers reap benefits from business as usual in urban transportation, why would they consider such a fundamental change as privatization? Privatization will only become attractive to them when the burden of financing public deficits and coping with complaints about inefficient and unresponsive service finally overwhelm the joys of political patronage. Current transit losses are large and growing, but the recent successes in eliminating deficits in both Federal and state budgets have temporarily relieved the pressure to cut wasteful spending on transportation. There is no better evidence of this than the "compromise" that produced the T21 legislation, with increased Federal funding for all modes of urban travel.

Eventually, I believe the political cost of sustaining urban transportation systems plagued by deficits and deteriorating performance will spur change. My hope is that policy makers will find it in their interest to act sooner rather than later, encouraging experiments in private urban transportation. Properly conducted, these experiments should generate popular support for privatization and pave the way toward a more efficient urban transportation system.

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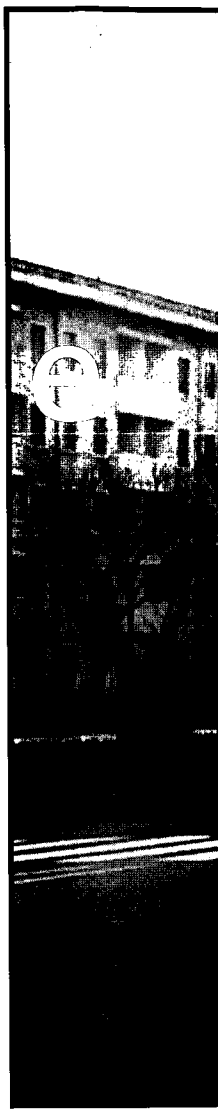
Stumbling Toward Apocalypse

The Economics of Korean Unification



By Marcus Noland

Winston Churchill once called Stalinist Russia "a riddle wrapped in a mystery inside an enigma." What might he have made of the geopolitical catastrophe that is contemporary North Korea?

No one knows exactly how many people have died in the current North Korean famine. Most guesses are around two million, or nearly 10 percent of the pre-crisis population – though no one is certain what that was, either. North Korea may have a nuclear weapon. Or it may have several. Or it may have none. No one outside of Pyongyang knows for sure, but many are concerned. Indeed, the potential fallout – figurative or literal – from the collapse of the North Korean government, has created some strange bedfellows: Today, North Korea is the largest recipient of United States assistance in Asia.

Some day, some way, the two Koreas will become one. German unification could illuminate the path.

PEOPLE'S REPUBLIC OF MISERY

The Democratic People's Republic of Korea (D.P.R.K.) was established under Soviet tutelage in 1948. After failing to unify the peninsula by force, founder Kim Il-Sung

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RON MCMILLAN/GAMMA LIAISON

set about to construct an orthodox Stalinist state – a task to which the Great Leader applied himself with a vengeance. Yet despite the official ideology of *juche*, or self-reliance, this was self-reliance of a very strange sort. While constructing the world's most autarkic economy, the North Koreans managed to extract substantial resources first from the Soviets and later the Chinese, apparently regarding these inflows as a form of tribute rather than a sign of weakness. Western bankers learned a bit about *juche* in the mid-1970's when the North Koreans defaulted on billions of dollars in loans.

It was fun (for some) while it lasted, but by the mid-1980's things began to sour. The disenchanted Soviets began demanding repayment on decades of loans and succeeded in reversing the net flow of transfers. Then the Iran-Iraq War ended, depriving the North

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Koreans of a major export opportunity – they had been selling arms to both sides. Finally, with the collapse of the Soviet Bloc in 1990, North Korea lost access to imports that did not require payment in hard currency.

Shut off from nearly all international commercial transactions, the North Korean economy deteriorated rapidly. The following year the government launched a "let's eat only two meals a day" campaign, and in 1994 North Korean radio broadcasts admitted the existence of hunger. In May 1995, South Korean President Kim Young Sam (whom the North Koreans would regularly vilify as a "puppet," a "traitor" and a "whore") made an unconditional public offer of emergency assistance to the North. The following month a deal was struck among Pyongyang, Seoul and Tokyo for the provision of food.

For decades the D.P.R.K. had been quixotically attempting to achieve food security through self-sufficiency. Due to its northerly latitude, short growing seasons and lack of arable land, this required highly intensive cultivation along with the most intensive use of agricultural chemicals in the world. Hillsides were denuded as increasingly inappropriate land was brought into cultivation, and the resulting erosion led to river silting. By no coincidence, unusually heavy seasonal rains in July and August 1995 triggered catastrophic floods.

Both the North Korean government and the international aid community portrayed the emerging famine as a product of natural disaster. But this famine was less an act of God than the culmination of decades of economic and ecological mismanagement.

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NUKES FOR SALE

While stumbling into famine, North Korea was also drifting toward military confrontation with the United States. North Korea had begun an experimental nuclear program with Soviet assistance in the 1950's. As a condition for their help, the Soviets had insisted that the North Koreans accept the obligations of the Nuclear Non-Proliferation Treaty despite the fact that they were not signatories. Then in 1985 the U.S.S.R. agreed to supply four light-water reactors on the condition that the D.P.R.K. sign the non-proliferation pact. North Korea did, but soon thereafter the Soviet Union collapsed. The ironic upshot: the North Koreans were formally obligated by the treaty, yet had not obtained the Soviet reactors.

Having been hoodwinked by Iraq, the International Atomic Energy Agency (the organization tasked with preventing nuclear proliferation) was determined not to be fooled again. In May 1992 an agency inspection team confirmed United States intelligence findings that the North Koreans were building facilities capable of producing weapons and possibly had enough weapons-grade plutonium to make one or two "Hiroshima-size" bombs. What followed was a period of deteriorating diplomatic relations, highlighted by a North Korean statement (later "suspended") that it would withdraw from the non-proliferation treaty. In May 1994 the D.P.R.K. proceeded with the removal of spent fuel rods from their reactors, making it impossible to construct a reliable account of the disposition of North Korea's fissionable materials.

Although the United States had lived with the threat from tens of thousands of troops arrayed along the northern border of the

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TOP: GERHARD JOREN/SYGMA, BOTTOM: ABRAITYTE/SYGMA

Great Leader Kim Il-Sung and his son, Dear Leader Kim Jung-Il.

demilitarized zone for 40 years, the specter of a cash-strapped North Korea selling nuclear weapons and missile delivery systems to the highest bidder was something else entirely. The United States began preparing for war on the peninsula.

Enter former President Jimmy Carter. On his own initiative, Carter decided to pay a call on another visionary, the Great Leader, Kim Il-Sung. On the evening of June 16, while General John Shalikashvili, chairman of the United States Joint Chiefs of Staff, was in the White House presenting the war plan to President Clinton for his approval, Carter and Kim agreed that the D.P.R.K. would freeze its nuclear activities and halt the planned expulsion of the International Atomic Energy Agency. In return Carter would recommend that the United States support the D.P.R.K.'s acquisition of light-water reactors, along with a resumption of the United States–D.P.R.K. nuclear meetings. Carter then called the White House, interrupting Shalikashvili's presentation to relay the import of his conversation with Kim and inform the White House that, having averted nuclear war, he was about to spread the good news via a live interview on the Cable News Network.

Nuclear confrontation defused, diplomatic talks resumed the following month. But in July the Great Leader died. With the United States and South Korean governments convinced that the D.P.R.K. would collapse within a couple of years – if not a couple of weeks – and that any reactors would become the property of the current South Korean government, the United States and the D.P.R.K. concluded their Agreed Framework. The deal: North Korea froze its own nuclear development program in exchange for two light-water reactors worth billions of dollars.

TIN-CUP DICTATOR

Upon the death of his father, Kim Jong-Il (a.k.a. the Dear Leader), became the D.P.R.K.'s paramount chief. Kim fils inherited a country with a collapsing economy on the brink of a famine. The Chinese, who had taken up some of the slack after the Soviets had withdrawn support, were no help; they, too, had become disenchanted and were scaling back aid.

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In this situation, one obvious course of action would have been to take a page out of China's book and liberalize the economy – as the Chinese have urged. However, reform would have had profound and unwanted effects on North Korea's leadership. First, there would be a significant increase in exposure to international trade and investment, the bulk of which with South Korea and Japan, countries maintaining problematic relations with the D.P.R.K. Second, changes in the composition of output in a heretofore-autarkic economy would be tremendous, forcing literally millions of workers to change employment. Both developments could be expected to have enormous domestic political implications.

Indeed, North Korea's reform path would be more difficult than the ones traversed by China and Vietnam, Asia's other major transitional economies. At the time they initiated reforms, China and Vietnam had more than double the share of population employed in the agricultural sector than North Korea apparently has today, and their reform strategies were facilitated by the existence of this enormous pool of low-productivity labor. A transition route hewn from surplus agricultural labor is simply not available to North Korea, which in economic terms more closely resembles the over-industrialized economies of the former Soviet bloc than it does China or Vietnam.

The second hurdle that reformers would face is ideological. Consider the case of Vietnam. The North Vietnamese government and its Vietcong allies defeated the South Vietnamese government in a civil war, allowing Vietnamese communists to claim an ideological victory in the united Vietnam. Likewise, while China has had to contend with the rump of Taiwan, no one seriously has claimed that the survival of Taiwan represented an ideological threat to the Chinese government. Thus reformers in both China and Vietnam had been relatively free to construct rationalizations – albeit tortured – about how their market-oriented reforms were what Marx or Mao or Ho really had in mind.

The ideological terrain faced by the current North Korean regime is very different. Rather than monopolist purveyors or dominant definers of national ideology, the North Koreans are very junior partners to South Korea in both size and achievement. Moreover, the dynastic aspects of the Kim regime make it even more difficult for the son to disavow the legacy of the father. While the ideologues of Pyongyang could certainly turn ideological somersaults to reinterpret *juche* to mean market-oriented reform, the existence of a prosperous, democratic South Korea makes their task very difficult. After all, why be a second-rate imitation South Korean when one can head south and become the real thing?

This, of course, raises a third point. Reform would mean vastly increased exposure to the outside world, in particular to South Korea and Japan. While today's North Korean economy has latent, unexploited potential, its isolation reduces opportunities to transform this potential into products that the rest of the world wants to buy. In China, after all – an economy with internal command over relatively sophisticated technology – enterprises bolstered by foreign investment still account for 40 percent of exports. In prosaic terms, North Korean enterprises need blueprints as well as worldwide distribution and marketing networks.

Foreign direct investment (and through it, an infusion of new technology and management) would undoubtedly play a key role in

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creating the necessary links between domestic resources and world markets. However, the most likely investors in North Korea are companies from South Korea and Japan, and United States economic sanctions are a disincentive for potential investors.

It is unlikely that either Japan or the United States would normalize relations with North Korea without significant improvements in North-South relations. Indeed, this issue looms over any strategy for salvaging the North Korean government without bringing down the government.

Normalization with Japan would permit the Japanese government's investment guaranty agency to insure Japanese investments in North Korea, paving the way for mainstream companies to make large-scale investments. Normalization with the United States would permit the termination of the embargo – and the disincentive it presents to potential investors of all nations. Thus even with the "right policies," a series of diplomatic tumblers would have to fall into place for an export-led reform strategy to work.

The extent to which Kim Jong-Il is motivated by this reasoning is unknown. What is apparent, however, is that the North Koreans have not approached economic reforms in a serious way. Although a constitutional revision promulgated in August 1998 mentions "private property" (Article 24), "material incentives" (Article 32) and "cost, price, and profit" (Article 33), the pronouncements are

FOOD FOR TALKS – WHO SEZ CRIME DOESN'T PAY?

DATE	VALUE	FORM	CHANNEL	DIPLOMATIC OBJECTIVE
February 1996	$2 million	food	World Food Programme	Encourage North Korean adherence to the Agreed Framework during a period of increasing tension between the two Koreas.
June 1996	$6.2 million	food	World Food Programme	Encourage North Korean flexibility with respect to a secret proposal for four-way talks between the US, North Korea, South Korea, and China.
February 1997	$10 million	food	World Food Programme	Quid pro quo for North Korean agreement to participate in joint US - South Korea briefing on Four-Way Talks proposal.
April 1997	$15 million	50,000 metric tons of food	World Food Programme	Quid pro quo for North Korean agreement to participate in missile proliferation negotiations.
July 1997	$27 million	100,000 metric tons of food	World Food Programme	Quid pro quo for North Korean agreement to participate in Four-Way Talks.
October 1997	$5 million	grant	UNICEF	Quid pro quo for North Korean acceptance of 10 additional food relief monitors.
February 1998	n.a.	200,000 metric tons of food	World Food Programme	Quid pro quo for North Korean agreement to participate in ad hoc committee meeting associated with the Four-Way Talks.
September 1998	n.a.	300,000 metric tons of food	World Food Programme	Quid pro quo for North Korean agreement to resume missile talks, attend the third plenary session of the Four-Way Talks, enter into negotiations over the second suspected nuclear site, and resume talks aimed at removing North Korea from the list of states.

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in the context of an otherwise orthodox elaboration of a planned, self-reliant economy. It appears, moreover, that some prominent "reformers" have been purged and the Committee for the Promotion of External Economic Cooperation, the body tasked with encouraging international trade and investment, has been dissolved in the recent governmental reorganization.

Instead, the North Koreans have tried to preserve their centrally controlled system while pursuing a two-track strategy to generate badly needed foreign exchange: one-time revenue schemes that do not alter the organization of the economy, and strategic brinkmanship to extract resources from the rest of the world.

Examples of the former include, the Rajin-Sonbong Trade and Economic Zone (née the Free Trade and Economic Zone – Kim Jong-Il didn't like the adjective "free" and had the name changed), a failed export processing zone in the extreme northeastern part of the country, and the Mt. Kumgang tourism venture with Hyundai. In both cases the projects were literally fenced off from the rest of the economy.

The other track is to extort foreign aid. On eight occasions the United States government has provided North Korea with food to induce North Korean participation in diplomatic talks. The use of brinkmanship with respect to the military is more ominous. In August 1998 North Korea publicly admitted that it was exporting missiles – and then asked the United States for $1 billion to discontinue the practice. The following month it invited prospective buyers in for a visit, and then without warning fired a multi-stage rocket across Japan. Most recently, the D.P.R.K. and the United States have engaged in talks over a second suspect nuclear site. The North Koreans initially asked for $300 million for a single inspection of the site, but now say that they would be willing to accept another donation of food, instead.

The marriage of the rocket and nuclear programs would give the North Koreans impressive tools with which to intimidate their neighbors and create proliferation nightmares for the United States. North Korea could continue to play the extortion game, offering to abandon weapons development and export while continuing to make clandestine sales. Stepping back, the most frightening aspect to this scenario is that it represents a continuation of the status quo. In light of the previously noted obstacles to reform, such an externally high-risk strategy may well be the path of least resistance for a weak and risk-averse regime.

Despite the limited success of the North Koreans, it is doubtful that extortion is a sustainable development strategy.

Despite the limited success of the North Koreans in using such tactics, it is doubtful that, absent reform, extortion is a sustainable development strategy. In the end it is quite possible – some would say probable – that the regime will prove incapable or unwilling to make the economic and diplomatic moves necessary to insure its own survival. While the United States, South Korea, China, Japan and others may attempt to sustain the North

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Korean regime, intention does not insure outcome. History is replete with examples of countries and regimes that did not go the way that their patrons desired.

SUNSHINE OR MOONSHINE?

In December 1997, former dissident Kim Dae Jung was elected president of South Korea, and articulated a policy toward North Korea based on three principles. First, no provocations would be tolerated – i.e., the United States-Republic of Korea military alliance would remain a cornerstone of South Korea's policy. Second, economic initiatives with North Korea would be separated from politics. Third, South Korea would not seek to undermine or absorb North Korea.

This so-called sunshine policy is based on the proposition that with enough constructive engagement, North Korea can be weaned away from confrontation. But even before Kim's statement, the South Korean passion for unification had begun to cool as the potential costs became more apparent and the South Koreans became preoccupied with their own economic crisis.

The putative model underlying the sunshine policy, German unification in 1989, is often thought of as a failure. For nearly a decade and a trillion dollars worth of transfers after the fact, unemployment in the former East Germany remains at more than 17 percent. But this judgement may be overly harsh. The Germans did, after all, achieve national unification through the peaceful liberation of a communist state. Faced with a starving, possibly nuclear-armed, experiment in dynastic totalitarianism, would only the South Koreans be so lucky.

Suppose they did get lucky and North Korea collapsed without lashing out or descending into anarchy. What would be the implications for South Korea?

The Korean case could be more problematic than the German experience for two reasons. North Korea is relatively larger and poorer in comparison to South Korea than East Germany was compared to West Germany. Then, too, North Korea is in more dire straits today than East Germany was at the fall of the Wall.

By the same token, Korea appears better off in some ways. Korea (North Korea in particular) is demographically younger than Germany. Young people are presumably more adaptable than old people. What's more, conventional education can be used for training young people, reducing the need for adult-retraining initiatives.

Much of the North Korean population lives within 100 miles of the demilitarized zone, a reality that casts a long shadow over any analysis of economic unification between the two Koreas. Migration, after all, acts as a substitute for the movement of capital. The more that labor is allowed to migrate south, the lower the amount of capital necessary to reconstruct the North Korean economy.

If no investment were made and North Koreans were free to move south, North Korea would be virtually depopulated before differences in labor productivity were sufficiently narrowed to choke off the incentive to migrate. Conversely, I estimate that if incomes in North Korea were raised solely by infusions of capital, the amount needed to choke off the incentive to migrate could be as high as $1 trillion. Presumably, neither of these extreme approaches would be acceptable to South Korea. So the real issue is how to fashion an intermediate solution that would involve a combination of cross-border movements of both labor and capital.

Of course efficiently allocated investment generates profits, not just costs, and it is possible to imagine unification scenarios in

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which South Korea comes out a winner from investments in the North. Moreover, the "peace dividend" associated with military demobilization on both sides and elimination of redundant government security agencies would be considerable, easily amounting to billions of dollars annually.

The point is not that unification would necessarily benefit the South Korean economy – it is not difficult to imagine scenarios in which it is made worse off, in some cases significantly so. But rather that unification offers the possibility of increasing useful output for Korea as a whole. Even if unification boosted the aggregate economy, though, there is no guarantee that every South Korean would benefit. Indeed, unification would have significant implications for who gets what.

The addition of millions of unskilled workers from the North would transfer income toward the owners of capital and away from labor – and, within labor, from lower- to higher-skilled groups. To the extent that the highly skilled are also the predominate owners of capital, unification would cause greater income and wealth inequality in the South.

Moreover, unless the government responded with offsetting policies, foreign capital inflows could lead to an exchange-rate appreciation in Korea. This would hurt sectors subject to international competition such as manufacturing, while helping untraded goods and services such as construction. Put more simply, if you are a South Korean blue-collar worker in a low-tech factory, your cousins in the North represent a threat. By contrast, if you are a South Korean construction magnate with savings to invest, Korean unification could be very, very good for you.

The economic policy variables of unification boil down to this: Southerners can send money north, or northerners can be permitted to head south.

And, it need not be said, the policies that are ultimately adopted will be a function of politics. A number of fault lines could appear: between the North and the South, between South Korean capital and labor forces, and within South Korea between the traded- and domestic-goods sectors.

It is possible to conceive of policies that would deny North Koreans most of the economic gains from unification. South Korea might maintain the military border and administer North Korea as a Special Administrative Zone, preventing the equilibration of wages and rates of return on capital between the North and South. Or, in theory, the South Korean government could confiscate the assets in the North. But these would only be viable if North Koreans were denied political rights. Thus a key economic question is the terms on which today's North Koreans participate in the political system of a unified Korea.

LESSONS FROM GERMANY

Korea does have an opportunity to learn from Germany's mistakes. Conventional wisdom has it that German monetary authorities made a fundamental – and avoidable – mistake in setting the conversion rate between West and East German marks at one-to-one. This is not true. While one can argue over the equity of crediting eastern Germans with western D-marks at parity, the policy represented a manageable, one-time transfer of wealth from the rich West to the poor East.

The fundamental mistake affecting economic efficiency was in the subsequent wage policy that pushed East German wages far above competitive levels, creating massive unemployment and necessitating large social welfare expenditures in the East. Wages were artificially raised in the East, not because the

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Germans were stupid, but because West German labor unions feared competition from their East German counterparts and no one in the negotiations represented the interests of future owners of East German capital.

That suggests a partial solution for Korea. If South Korea wants to give Northerners an incentive to stay at home, the government should assign property rights to land and housing to current residents contingent on some period of continued residence.

More broadly, the lesson from the other transition economies is that one must privatize quickly – not because private managers are uniquely competent (though they may be), but because without clear property rights and privatization, there will be no investment. Without investment, there cannot be economic rehabilitation.

In this respect, the Germans made two related mistakes. They tried to restructure enterprises by fiat before putting them on the market, thereby slowing the process of privatization. Better to get the assets into private hands and let markets, not bureaucrats, handle restructuring.

Second, they accepted the principle of restitution whereby people could claim assets confiscated by the Communist regime. This led to claims and counterclaims, leaving properties to deteriorate in limbo. If South Korea decided to compensate previous owners in North Korea, it would be better to do so through monetary compensation – not though reassignment of ownership to the disputed asset.

The priorities are clear: Get assets into a responsible owner's hands as quickly as possible, and begin the rehabilitation process. The issue of whether someone should receive a payment from the state for an allegedly seized asset can be settled later: after all, if the asset was confiscated a half-century ago, another year or two wait for compensation is unlikely to be important.

Rapid privatization does not necessarily

DÉJA VU ALL OVER AGAIN?

	EAST GERMANY	WEST GERMANY	NORTH KOREA	SOUTH KOREA
	1988		1997	
POPULATION (MILLIONS)	17	61	22	45
LIFE EXPECTANCY (YEARS)	73	70	51	74
AREA (1,000 SQ MILES)	42	97	47	39
PER CAPITA INCOME ($ PURCHASING POWER)	8,500	14,900	900	9,600
EXPORTS ($ BILLIONS)	28	243	1	137
IMPORTS ($ BILLIONS)	27	191	2	145

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mean cash auctions, however. In the German case, East Germans had virtually no financial assets and certainly little buying power relative to the West Germans. The German government's demand for cash payment in exchange for assets formerly held by the East German state effectively excluded East Germans from the privatization process, and more than 90 percent of the assets eventually ended up in West German hands. To prevent this from happening in North Korea, models such as the Czech voucher system, which gave every citizen an equal slice of newly privatized property, should be considered.

CORBIS/REUTERS

Finally, maintaining production in the North would be a priority. There are at least two important issues here. First, there would be a need for well-functioning capital markets to channel investment into the North. If, as widely assumed, unification occurs through collapse, the process of absorption will inevitably focus attention on the state of South Korean capital markets – and the picture is not pretty.

South Korea needs to restructure its banking system, improve the operation of its bond market, create a better climate for foreign direct investment and better integrate foreigners into its financial markets. Compared with the German case, Korea will likely face greater challenges with a far-less-efficient financial system to re-channel resources. From this perspective, the current financial crisis in South Korea and the resulting expedited liberalization of South Korean financial markets could prove a blessing in disguise.

"If one wants the prosperity of the national economy, he should thoroughly reject the idea of dependence on outside forces, the idea that he cannot live without foreign capital... Ours is an independent economic structure equipped with all the economic sectors in good harmony and with its own strong heavy industry at the core. It is incomparably better than the export-oriented economic structure dependent on other countries... We must heighten vigilance against the imperialists' moves to induce us to 'reform' and 'opening to the outside world.' 'Reform' and 'opening' on their lips are a honey-coated poison. Clear is our stand toward 'reform' and 'opening.' We now have nothing to 'reform' and 'open.' By 'reform' and 'opening' the imperialists mean a revival of capitalism. The best way of blocking the wind of 'reform' and 'opening' of the imperialists is to defend the socialist principle in all sectors of the economy... We will never abandon the principle, but will set ourselves against all attempts to induce us to join an 'integrated' world."

– From a joint editorial published by Rodong Sinbum, the newspaper of the Central Committee of the Korean Workers Party, and Kunroja, the Central Committee's political theory magazine, September 17, 1998.

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A second aspect of this problem involves the role of West German – more to the point, South Korean – companies in their new markets. In the case of East Germany, a flood of West German consumer goods temporarily depressed local production. West German companies also attempted to take over potential competitors in the East, either shutting them down or turning them into sales offices. They were blocked by the West German Cartel Office. Similar dangers are obvious in Korea. But unlike Germany, South Korea does not have an antitrust authority capable of blocking anticompetitive actions by the chaebols, the powerful conglomerates.

DENOUEMENT

North Korea is experiencing a humanitarian nightmare internally and poses a strategic threat externally. From the American perspective, probably the best solution would be the internal collapse of the Kim Jong-Il regime. However, with 10,000 artillery weapons deployed near the border, the North Koreans effectively hold hostage Seoul's 15 million residents. North Korea's neighbors, who might experience the fallout from an untimely end to Kim Jong-Il far more directly than America, are unenthusiastic about such an alternative. As a consequence, the United States and its allies are forced to pursue second-best alternatives.

America, South Korea, Japan, China and others have slipped into an ad hoc policy of propping up the Kim Jong-Il regime. Can it work in the long run? North Korean provocations have already badly undercut domestic political support for engagement in the United States, and Japan. South Korean President Kim Dae Jung continues to pursue his "sunshine" policy. But unless he can begin to show some tangible gains, support for such a policy in South Korea will evaporate as well.

That leaves China. North Korea may eventually revert to a Chinese tributary state – its status for much of the past millennium, and an inversion of the self-reliance ideology of Great Leader Kim Il-Sung. But even the Chinese have limited influence on the North. In the end the regime's internal rigidity may make it impossible to sustain, even with Chinese assistance. The problem is that there is no guarantee that the D.P.R.K. would disappear quietly.

Even if North Korea were to exit with a whimper rather than a bang, the challenges that this could present to South Korea would be enormous. North Korea's is a larger, poorer and more distorted economy than the former East Germany's. Moreover, unlike the Germans, the Koreans fought a horrific civil war that will exacerbate political differences created by decades of isolation.

Differences in living standards between the North and South are overwhelming. The North Korean population is young and Seoul glows like a beacon just south of the DMZ. Unless they are forcibly restrained, one must assume that large numbers of North Koreans will head south if given the opportunity. If they were restrained, pressures for cross-border migration would persist until the income gap was substantially reduced. This could require hundreds of billions of dollars of capital investment and considerable transfer of technology.

As a consequence, the political rights afforded to the residents of North Korea will likely prove the key determinant of economic outcomes, affecting the assignment of property rights and the extent of cross-border migration. Thus for all the economic problems, absorbing North Koreans into the emerging liberal political culture of South Korea looms as the critical challenge of unification. M

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Once again, it's time to play stump the experts (you). For your entertainment and edification, we offer an acrostic. For those (like the editor) who have always ignored such puzzles, directions are printed below.

We couldn't come up with an acrostic whose clues were tied to the mission of The Milken Institute Review. But there is still redeeming educational significance here: The answer to the puzzle is a quotation from the writings of a wise and witty modern economist with a crew cut.

And then there's the matter of pedigree: Steven Postrel, the creator of the puzzle, has a Ph.D. in economics from M.I.T. and teaches at the University of California (Irvine) Graduate School of Management. Steve's labors should be an inspiration to us all – proof that obsessive-compulsive behavior can be its own reward.

O 1	B 2	S 3	A 4	■	F 5	M 6	O 7	V 8	U 9	■	W 10	E 11	H 12	Q 13	J 14	G 15	D 16	B 17	A 18	O 19	■	C 20	N 21	O 22
■	T 23	M 24	W 25	K 26	■	A 27	■	B 28	M 29	E 30	R 31	D 32	O 33	■	N 34	J 35	L 36	E 37	T 38	Q 39	J 40	H 41	M 42	■
I 43	P 44	N 45	Q 46	■	B 47	U 48	■	D 49	K 50	B 51	■	E 52	H 53	G 54	E 55	N 56	Q 57	J 58	■	C 59	B 60	■	N 61	Y 62
H 63	■	W 64	X 65	Q 66	R 67	E 68	L 69	I 70	■	U 71	T 72	O 73	E 74	J 75	G 76	K 77	J 78	J 79	K 80	■	P 81	Y 82	R 83	D 84
H 85	P 86	V 87	I 88	N 89	■	F 90	D 91	C 92	W 93	■	I 94	E 95	N 96	R 97	■	L 98	M 99	D 100	■	E 101	X 102	R 103	T 104	G 105
F 106	X 107	■	C 108	A 109	F 110	K 111	B 112	U 113	■	E 114	J 115	F 116	G 117	■	I 118	H 119	S 120	R 121	K 122	B 123	U 124	T 125	J 126	X 127
T 128	X 129	■	E 130	E 131	■	F 132	D 133	H 134	R 135	N 136	I 137	D 138	■	G 139	T 140	Y 141	P 142	A 143	H 144	V 145	X 146	A 147	■	X 148
U 149	X 150	■	Q 151	O 152	X 153	J 154	A 155	T 156	X 157	G 158	K 159	B 160	D 161	S 162	■	Y 163	C 164	M 165	K 166	U 167	V 168	N 169	Y 170	■

After answering each clue, copy the letters to the corresponding numbers in the grid, where they will form a quotation. Words begin and end at shaded squares, and so may continue from one row to the next. The first letters of each answer, when spelled in order, give the author and publication of the quotation.

Answers on page 60.

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A. Leftover ___ ___ ___ ___ ___ ___ ___
143 109 155 4 27 147 18

B. Attack ___ ___ ___ ___ ___ ___ ___ ___ ___
47 28 60 51 112 17 123 2 160

C. Wind-scattered ___ ___ ___ ___ ___
108 92 59 20 164

D. Peel off in flakes ___ ___ ___ ___ ___ ___ ___ ___ ___
100 138 84 133 161 16 32 49 91

E. Alternative to a pushbutton (2 wds) ___ ___ ___ ___ ___ ___ ___ ___ ___ ___ ___ ___
30 68 11 55 74 101 131 52 130 114 37 95

F. Muscle contraction ___ ___ ___ ___ ___ ___
5 90 116 106 132 110

G. Infer; guess ___ ___ ___ ___ ___ ___ ___
117 139 54 15 105 76 158

H. Mileage indicator ___ ___ ___ ___ ___ ___ ___ ___
12 119 53 134 85 144 63 41

I. Humor; high spirits ___ ___ ___ ___ ___ ___
88 137 43 118 94 70

J. Perpendicular ___ ___ ___ ___ ___ ___ ___ ___ ___ ___
154 75 126 115 14 58 40 79 78 35

K. Pared down ___ ___ ___ ___ ___ ___ ___ ___
166 50 111 159 77 122 26 80

L. Macho cat ___ ___ ___
98 36 69

M. Water pipe ___ ___ ___ ___ ___ ___
6 165 29 42 24 99

N. Consistent with one's obligations ___ ___ ___ ___ ___ ___ ___ ___ ___
45 61 21 56 34 96 136 169 89

O. Soup additive ___ ___ ___ ___ ___ ___ ___
152 22 7 73 33 1 19

P. Big story ___ ___ ___ ___
142 81 44 86

Q. Sift; sort; separate ___ ___ ___ ___ ___ ___
46 151 13 57 66 39

R. Widespread; uncontained ___ ___ ___ ___ ___ ___ ___
83 103 31 135 121 67 97

S. Stare at ___ ___ ___
3 162 120

T. Whale food ___ ___ ___ ___ ___ ___ ___ ___
156 104 125 140 38 23 128 72

U. Composed ___ ___ ___ ___ ___ ___ ___
71 149 48 167 124 9 113

V. Night fliers ___ ___ ___ ___
168 145 87 8

W. Onion cousin ___ ___ ___ ___
93 64 10 25

X. Crude remark or gesture ___ ___ ___ ___ ___ ___ ___ ___ ___ ___
146 129 150 102 157 127 65 148 153 107

Y. Nerve ___ ___ ___ ___ ___
141 62 82 170 163

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Today's Smokers,

This is what the good life means in China today: A rural factory worker has something extra in his pocket at the end of the week. He celebrates by visiting the butcher and bringing home steaks, so his family can have a taste of prosperity.

The good life could also mean giving small gifts to friends. When two office workers meet in Shanghai, for example, it's common for one to offer the other a cigarette. The standard response is to take it and inhale before beginning the conversation. To refuse a cigarette creates an awkward moment – after all, you are refusing a gift.

China has one-sixth of the world's population, and it is making the transition from

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TOP: DAVID MCINTYRE/BLACK STAR, BOTTOM: JAMES ZENG HUANG/SYGMA

poverty to relative affluence in less than one life span. The country's gross domestic product per capita doubled between 1978 and 1987, then doubled again between 1987 and 1996. This transformation has brought remarkable improvements. Life expectancy at birth has increased from 54 years in 1962 to 70 years in 1997, two years longer than the global average. Literacy has increased from 64 percent of adults in 1980 to 80 percent in 1995.

Yet there are less positive aspects to China's economic transition. Seven out of 10 men in China smoke cigarettes, and the average daily consumption (per man) has risen in virtual lockstep with income, from one cigarette in 1952 to four in 1972 and 11 in 1996. Tobacco already causes about 800,000 deaths a year in China, according to estimates released last fall. But the full impact of recent increases in consumption will not be felt for about 30 years.

In the middle of the 21st century, when today's new smokers are tomorrow's victims of lung cancer and heart disease, China can expect some 3 million tobacco-related deaths a year. Most of these premature deaths will be among men, because they smoke more than 90 percent of the 1.8 trillion cigarettes sold annually in China.

Poverty kills. But if China doesn't act soon, so will affluence.

Tomorrow's Statistics

China Meets The Marlboro Man

By Brad Edmondson

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TOMORROW'S STATISTICS

One reason for the long life expectancy of Chinese people is their low-fat diet. But China's economic transition is also increasing the proportion of calories Chinese consume as fat. Chinese beef consumption quadrupled between 1990 and 1995, for example, and the amount of grain used for animal feed increased from about 20 million tons in 1980 to about 85 million in 1995.

Any country that makes the transition from agrarian poverty to industrial wealth goes through a variety of changes, with long-term effects that go far beyond economics. The best known of these is a transition in health and illness. Countries whose national incomes are beginning to rise are often able to make rapid improvements in public health by drilling deep wells for drinking water, eliminating open sewers and other causes of infectious disease and providing basic modern medicines. These measures have immediate and dramatic impact on deaths from disease, especially among children.

But as the nation's life expectancy increases and incomes continue to rise, more people can afford to buy the traditional symbols of modern wealth and sophistication. Eating and leisure habits change, and the leading causes of death become more and more associated with old age and affluence. The most prominent of these is cancer.

Nutrition and disease experts are looking closely at connections between economic transitions and health transitions – and many of them see China as a test case for the rest of the developing world. Their hope is that China can achieve affluence while avoiding the health mistakes made by other rich countries, and tobacco control is their chief concern. One might expect the primary opposition to preventive measures would come from tobacco companies and government officials. But the biggest challenge will no doubt come from consumers. For when a newly prosperous wage earner in Beijing (or Mexico City or Bangkok) dreams of the good life, the dream usually includes steak, booze and smokes.

***BRAD EDMONDSON** is a Senior Fellow at the Center for the New West and the former Editor-in-Chief of **American Demographics** magazine.*

HAND-WASHING AND HOSPITALS

The health transition has happened in every industrial country in roughly the same way. In 1900, about 40 percent of deaths in the United States were caused by 11 major infectious diseases: typhoid, smallpox, scarlet fever, measles, whooping cough, diphtheria, influenza, tuberculosis, pneumonia, polio, and diseases of the digestive system. Only 16 percent of deaths were caused by cancer, stroke or heart disease. One life span later, the numbers had virtually reversed. In 1973, infectious diseases caused just 6 percent of deaths in the United States, while 58 percent were due to these three chronic conditions.

Researchers agree that hospitals, vaccines, and the other blessings of modern health care have been responsible for part of the change. But most can be traced to measures that are often taken for granted.

According to Thomas McKeown, a British physician who studied the decline in mortality in England and Wales, the biggest improvements came from the simplest things. In the 18th and much of the 19th century, mortality declines were entirely due to improvements in environmental conditions – cleaner drinking water and less exposure to sewage. Between 1900 and 1971, about three-quarters of the additional fall in mortality in England and Wales were due to control of infectious diseases through a variety of public and private health measures. Thus just one-quarter of the

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20th century decline was not attributable to the control of microorganisms.

Vaccines and antibiotics often get the credit for stopping microorganisms, but they don't deserve first billing. In 20th century England, advances against air-borne infectious diseases such as influenza were responsible for half of the decline in the death rate. The major reason for this advance was improvement in nutrition: England's rising standard of living allowed more people to eat a balanced diet and thereby maintain strong immune systems.

Water-borne diseases such as typhoid and food-borne diseases such as salmonella accounted for one-sixth and one-tenth of the mortality declines, respectively. The main cause of these declines was reduced exposure to the disease though better personal hygiene.

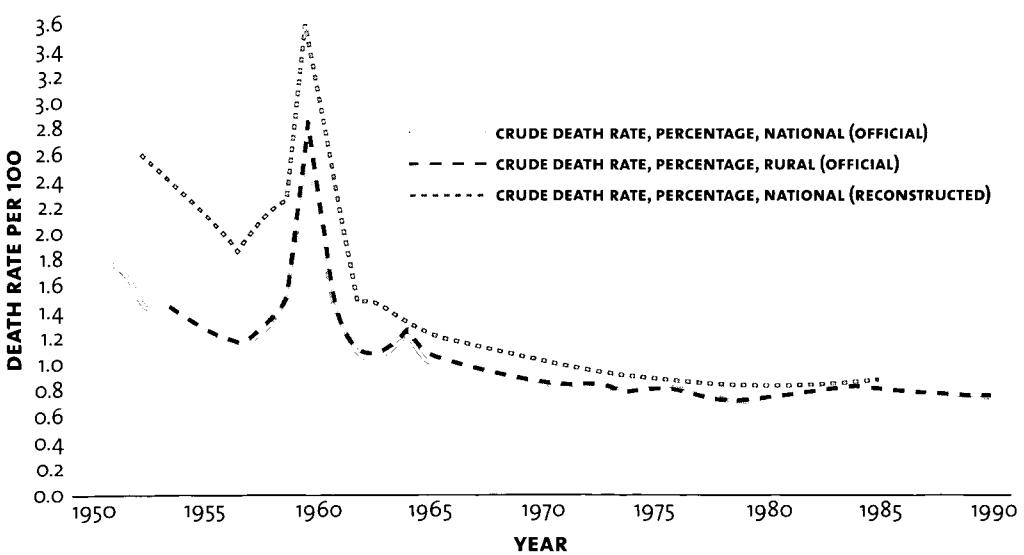
Medicine has had its share of triumphs: vaccines have made smallpox extinct on the planet, and they may soon eradicate polio. While our grandparents saw pneumonia as a death sentence, we have antibiotics. So we now view pneumonia as a serious but treatable condition. But medicine does not drive the health transition.

Indeed, medical measures are most useful as defensive weapons. They repel disease when it looms, providing a sense of security. Even so, the most potent weapons against disease are preventive measures that keep microorganisms from entering the body. John and Sonja McKinlay of Boston University

FINE, BUT FOR THE FAMINE

DEATH RATE AS PERCENTAGE OF TOTAL POPULATION, 1950-1990, CHINA

Sanitation and clean water campaigns dramatically cut Chinese mortality, except for the famine years of 1958-1962. A dramatic increase in cigarette smoking among men threatens to erode these gains.



SOURCE: Judith Banister, *China's Changing Population* (reconstructed rates); People's Republic of China (official rates).

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have pointed out that most of the increase in medical spending in 20th century America began in the mid-1950's. And by that time, mortality declines had already occurred for the majority of diseases vulnerable to miracle drugs.

RICH AND POOR DISEASES

Some of the best data on China's health transition come from The China Project, a joint venture of the Chinese Academy of Preventive Medicine, Oxford University and Cornell University. In the mid-1980's and again in the 1990's, researchers visited a sample of Chinese households to administer a battery of tests that included a lengthy health questionnaire, a basic medical exam and blood tests.

China is worth the effort because the rest of the world can learn from its example, argues Project co-director T. Colin Campbell of Cornell. After all, China is keeping more than a billion people relatively healthy on a diet that is low on animal products. It is also making a rapid transition from agrarian poverty to industrial wealth. But, at least so far, it has avoided many of the major diseases of Western countries.

Another strength of the China Project's data is that some areas surveyed are remote and still mostly unaffected by the nation's economic boom. Researchers used this geographic variation, along with information from Chinese mortality records, to look for causes of death correlated with poverty on the one hand and affluence on the other.

COURTESY OF HONG KONG COUNCIL ON SMOKING AND HEALTH

Propaganda to good purpose? An article on the dangers of smoking, from a Chinese newspaper.

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Their "diseases of poverty" include pneumonia; the associated problems of pregnancy and birth, and tuberculosis – all of which are concentrated in inland and northern China, where economic activity, population density and literacy rates are relatively low. Many people still do not follow basic rules of hygiene in these areas and many have little access to basic medical care.

The "diseases of wealth" are seven kinds of cancer, plus diabetes and heart disease. They are far more prevalent in urban coastal areas, where the economy has taken off and diets are more likely to include large amounts of meat, eggs, soy sauce, beer, processed carbohydrates and sugar. While the diseases of wealth are all strongly associated with old age, the risk of having them increases substantially for people who eat a diet rich in animal products and sugar, who smoke and who do not exercise.

Tobacco use is only one of many factors in the transition from diseases of poverty to diseases of wealth. But it attracts a lot of attention because it is strongly associated with a single consumer product – cigarettes – and because consumption of that product is associated with what economists call "discretionary" income.

According to a 1992 study by the World Health Organization, Poland consumes more cigarettes per adult than any other country in the world, at 3,620 cigarettes a year per resident aged 15 and older. Other countries in the top 10 are all affluent places such as Japan, Switzerland, the Netherlands and Australia. The United States ranks 11th, at 2,670 a year, and China (excluding Taiwan) ranks 32nd out of 100 countries rated, with 1,900 cigarettes per adult per year. Note that the numbers for China would top Poland if Chinese women also smoked.

Countries with the lowest consumption of cigarettes were extremely poor places such as Mozambique, Nigeria and Guatemala, which ranked last on the list with a per-adult figure of 340 cigarettes a year.

The connection between wealth and cigarette consumption is not absolute, however, and in recent years some wealthy countries have seen cigarette use move down the socioeconomic ladder. The percentage of Americans who smoke has declined sharply from 43 percent in 1966, when the landmark Surgeon General's Report on Smoking and Health was released, to about 25 percent today. But more than 30 percent of high school dropouts smoked in 1995, compared

HOW DEVELOPMENT DELAYS DEATH

In poorer countries, death often results from the lack of basic medical care. In richer countries, death associates with cancer and other conditions of old age.

DISEASES OF POVERTY	DISEASES OF AFFLUENCE
Pneumonia	Stomach cancer
Intestinal obstructions	Liver cancer
Peptic ulcer	Colon cancer
Other digestive disorders	Lung cancer
Nephritis	Breast cancer
Pulmonary tuberculosis	Leukemia
Infectious diseases (other than tuberculosis)	Diabetes
Parasitic diseases (other than schistosomiasis)	Coronary heart disease
Eclampsia	Brain cancer (ages 0-14)
Rheumatic heart disease	
Metabolic and endocrine disease (other than diabetes)	
Diseases of pregnancy and birth (other than eclampsia)	

SOURCE: T. Colin Campbell et al, "China: From Diseases of Poverty to Diseases of Affluence", in *Ecology of Food and Nutrition*, Vol. 27, p. 133-144.

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with 14 percent of college graduates. Contrast that with 1966, when college grads were more likely to be smokers than high school dropouts.

In the last decade, the class division among American smokers has become a chasm. Smoking is regarded as deviant behavior by many professionals in the United States, but cigarette breaks are still the rule in blue-collar work settings such as construction sites. People pressing for tobacco control in the developing world hope that they can use education to break the connection between cigarettes and discretionary income. At the same time, global tobacco companies are counting on this connection to open new markets. Governments are often caught in the middle: Their leaders may recognize the long-term folly of promoting tobacco, but they are attracted by easy tax revenues linked to tobacco sales. And once again, China offers the best example of these forces in action.

SMALL, RICH AND SMOKY

TOP COUNTRIES FOR CIGARETTE CONSUMPTION, PERSONS AGED 15 YEARS AND OLDER

Countries with the highest rates of cigarette use usually have relatively few people and are growing slowly, but have high household incomes.

RANK PER CAPITA	COUNTRY	CIGARETTES PER CAPITA 1992	POPULATION 2000	GROWTH RATE 1990-2000
1.	Poland	3,620	39,010	0.2%
2.	Greece	3,590	10,735	0.6%
3.	Hungary	3,260	19,795	-0.6%
4.	Japan	3,240	126,582	0.2%
5.	South Korea	3,010	47,351	1.0%
6.	Switzerland	2,910	7,374	0.8%
7.	Iceland	2,860	280	0.9%
8.	Netherlands	2,820	15,893	0.6%
9.	Yugoslavia*	2,800	10,140	0.4%
10.	Australia	2,710	18,950	1.1%
11.	United States	2,670	274,943	1.0%

** population figures are for Serbia only*

SOURCES: World Health Organization, U.S. Bureau of the Census

COST OF A CIGARETTE

As they enjoy their daily smokes, many Chinese consumers might remember the times when life was not nearly as good. Before the Red Army's victory in 1949, China endured decades of war that devastated the population. In the 1950's mortality fell sharply as social order was restored – but these improvements were temporary.

Forty years ago, Beijing's near-absolute control over the essentials of life created a catastrophe. Perhaps 30 million Chinese died because of the social experiment called The Great Leap Forward, which forced skilled farmers to become workers in bizarrely inefficient factories while making radical, ill-conceived changes in farm organization. The result was large-scale crop failures and famine from 1958 to 1961. According to the United States Census Bureau, the death rate went from an estimated 18 deaths per thousand in 1957 to 45 per thousand in 1960 – and then fell again to 14 per thousand in 1962.

Mortality had been on a steady decline before the famine, and death rates continued to decline for at least 15 years thereafter. Since 1984 an average of seven to eight Chinese per thousand dies each year – a rate slightly below that of the United States. But many Chinese still have first-hand memories of war, famine and the terror of the Cultural Revolution. To

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them the perils of cigarettes may seem small by comparison.

China's coming wave of smoking-related deaths will be quieter than the horrors of Maoism, but the death toll could be greater. As with The Great Leap Forward, China's tobacco epidemic will be closely linked to government actions: China recently became the world's leading tobacco producer, and some 90 percent of Chinese tobacco companies are owned by the government.

Europeans mainly owned the tobacco companies in China until they were nationalized at mid-century. In the last decade, however, the China National Tobacco Corporation has turned to Western companies including RJ Reynolds, Rothmans and Philip Morris for assistance in promoting their products. Western cigarette makers now sponsor Chinese sporting events that cater to young adults, such as the Marlboro Soccer League. At the Nightman disco in Beijing, young women hand out free 555-brand cigarettes and advertising banners for 555 encourage the dancers to "forget your worldly cares."

Private cigarette companies have three good reasons to join with the Chinese government. The first is to establish a presence in the country in hopes that their profits from legitimate Chinese sales will eventually rise. The second is to acquaint Chinese with their marketing messages, which fuel demand within the already-huge black market in cigarettes. And the third is to help China with its plans to become a major tobacco exporter.

Revenues from exports of Chinese tobacco have increased from virtually nil in 1980 to the equivalent of an estimated $600 million in 1995. China could well become the world's biggest tobacco exporter in a matter of decades, displacing all production in the United States.

Even as Beijing prepares these ambitious export plans, it apparently understands that smoking is a net drag on the Chinese economy. One study by Chinese researchers estimated that, in 1993, the tax revenues China earned from cigarettes were outweighed by the economic costs of smoking-related morbidity by the equivalent of $3 billion. Anti-smoking efforts began in China in the early 1980's, and stricter laws have recently taken effect. Advertising for cigarettes in print and electronic media has been banned since 1995. Smoking in most public places is illegal in 71 cities and three provinces.

However, tobacco companies get around the advertising ban by placing their well-

BIG COUNTRIES DON'T SMOKE MUCH (YET)

The most populated nations are often in the developing world, where the smoking habit is just starting to catch on.

RANK PER CAPITA	COUNTRY	CIGARETTES PER CAPITA 1992	POPULATION 2000	GROWTH RATE 1990-2000
1.	China	1,900	1,253,438	1.0%
2.	India	1,370	1,012,909	1.7%
3.	United States	2,670	274,943	1.0%
4.	Indonesia	1,180	219,267	1.6%
5.	Brazil	1,500	169,545	1.2%
6.	Russia	N/A	147,938	0.0%
7.	Pakistan	640	141,145	2.1%
8.	Bangladesh	990	132,081	1.8%
9.	Japan	3,240	126,582	0.2%
10.	Nigeria	370	117,328	3.0%
11.	Mexico	970	102,912	1.9%

SOURCES: *World Health Organization, U.S. Bureau of the Census*

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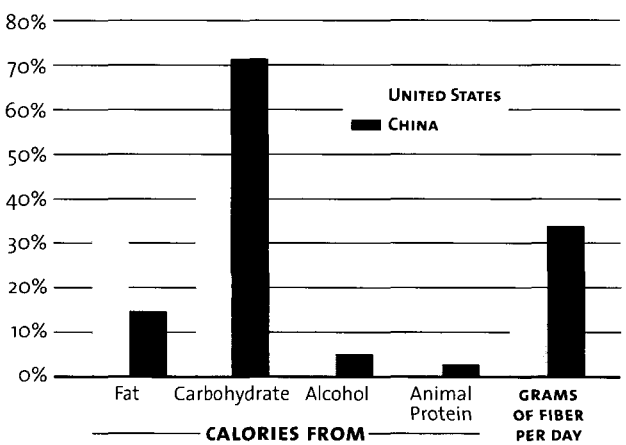
known brand logos and other images in advertising that does not how cigarettes. Getting the government to approve further controls on tobacco is complicated by the fact that tobacco is China's largest source of industrial tax revenue.

So far, the anti-smoking message is not getting through. More than half the Chinese people think smoking does little or no harm and, according to Dr. Yang Guanghua at the Chinese Academy of Preventative Medicine, six in 10 do not know that it can cause lung cancer. Perhaps most telling, 73 percent of Chinese men smoke – but only one percent identify themselves as former smokers.

WHY CHINESE FOOD IS GOOD FOR YOU

CALORIE DISTRIBUTION OF AVERAGE DIET, U.S. VERSUS CHINA, 1983

In 1990, China's diet was close to the ideal recommended to U.S. citizens by their government



SOURCE: Junshi Chen et al, *Diet, Lifestlye and Mortality in China.*

CHINA'S FUTURE: UP IN SMOKE?

Last fall, China's Academy of Medical Sciences and Oxford University released a study that brought China's health transition into sharp focus. Between 1989 and 1991, researchers visited the families and friends of one million people who had died in China between 1986 and 1988. If the person in question had died after age 35, the researchers determined whether he or she had been a smoker before 1980. If the person had been a smoker, the researchers gathered more information about his smoking habits. These data were then combined with cause-of-death information from death certificates.

The study was large enough and detailed enough to estimate, for the first time, the risk of death from various causes among Chinese smokers and non-smokers. Combining these risk ratios with population projections allowed the team to make the first large-scale projections of tobacco-related deaths in China.

Diseases associated with tobacco use already cause about 13 percent of deaths in Chinese men, and will probably account for 33 percent of male deaths if those who recently started smoking continue at their current rates of consumption. Yet smoking causes only about three percent of deaths in women, and is in decline because the rates of female smoking have actually fallen in recent years. Two-thirds of Chinese men now become smokers before the age of 25, and about half of those who persist will be killed by tobacco.

These proportions are similar to those found in affluent countries where widespread

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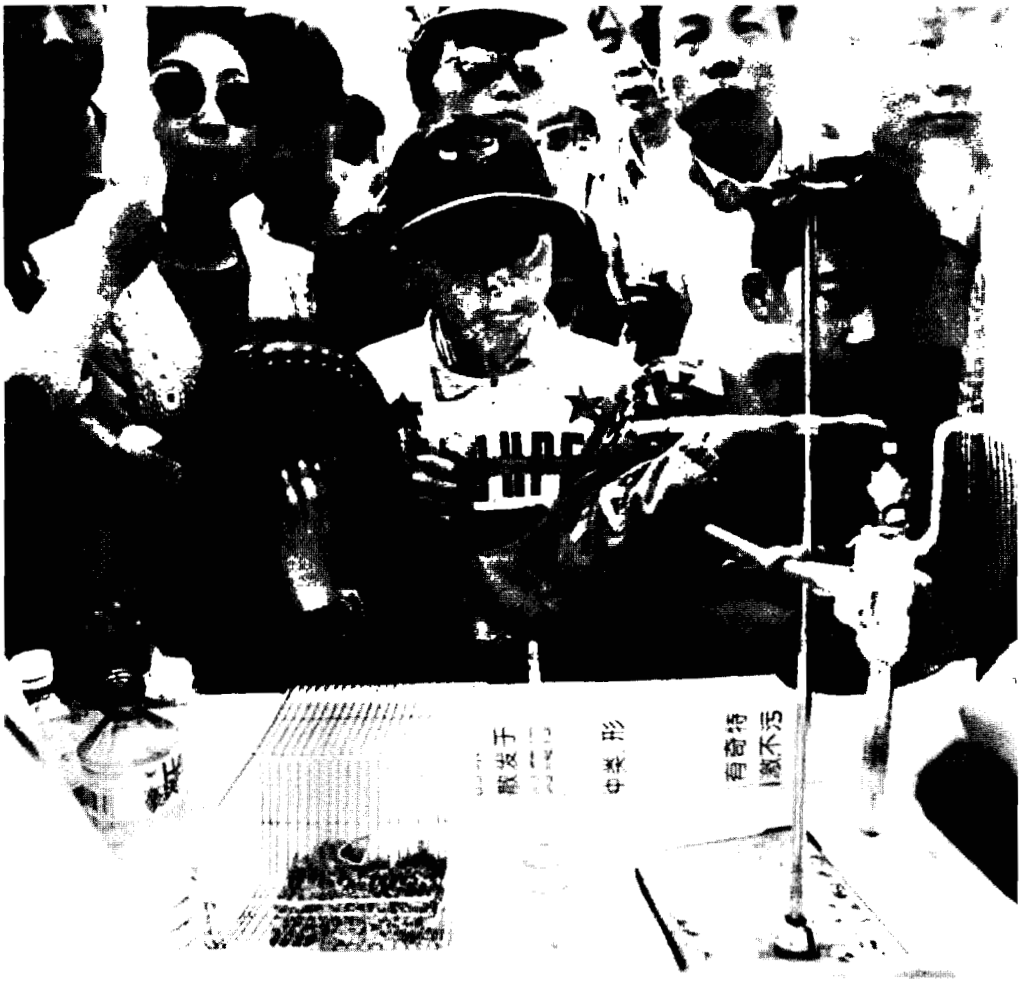

ASSOCIATED PRESS AP

Kids watch mice being asphyxiated by cigarette smoke at a Beijing health fair.

smoking has been common for three decades or more, such as the United States or France. The conclusion is inescapable: If the Chinese smoke like Americans, they will die like Americans.

The study estimated that 100 million of the 300 million Chinese males now under age 30 will eventually be killed by tobacco if they don't quit smoking. Tobacco caused about 600,000 deaths in China in 1990. But it will cause about 800,000 deaths in 2000 – and as many as 3 million a year by the middle of the next century if current smoking rates do not change.

Thirty years from now, if current rates continue, China will be a nation of relatively healthy women caring for sick and dying men. If Chinese women start smoking as their men do, China will become a nation of sick and dying spouses caring for each other.

These visions become even more disturbing when one realizes that the government-induced epidemic comes on the heels of another government policy – the "one-child

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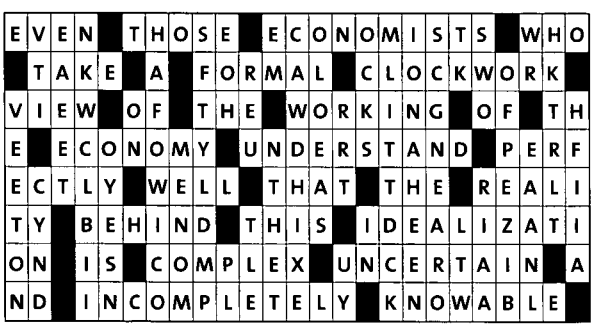
norm" – that placed heavy penalties on women bearing more than one child. Thanks to dramatic decreases in fertility, China is already one of the world's most rapidly aging nations. Thus it is entirely possible that China could become a nation of sick old men (and perhaps sick old women as well) with few children to provide care or pay their medical bills.

The choice of whether to smoke should be up to individuals, and few Westerners would favor more restrictions on Chinese freedom. Yet the health of an economy also depends on the health of its people, and smoking places China's status as the world's most desirable consumer market in serious jeopardy.

Judith Mackay, a longtime activist for tobacco control in China, sees the emergence of yet another kind of health transition – this one to a vigorous national program of preventive health measures. Nations that have gone through this transition, she says, will have active health education programs and extremely restrictive tobacco policies. Those that have not made the transition will struggle with rising morbidity, as well as entrenched tobacco interests that manipulate public opinion.

China still has time to make the leap to a preventative health care strategy. Indeed, in light of past "leaps," China may be in a better position than most countries to change behavior radically and quickly. Those who invest in China and the rest of the developing world would be wise to pay attention to the health transition. For in the long run, post-transition countries will be far more promising as consumer markets, as well as being far better places to live. M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PUZZLING ANSWERS

A. Leftover R E M N A N T
B. Attack O F F E N S I V E
C. Wind-scattered B L O W N
D. Peel off in flakes E X F O L I A T E
E. Alternative to a pushbutton (2 wds) R O C K E R S W I T C H
F. Muscle contraction T W I T C H
G. Infer; guess S U R M I S E
H. Mileage indicator O D O M E T E R
I. Humor; high spirits L E V I T Y
J. Perpendicular O R T H O G O N A L
K. Pared down W H I T T L E D
L. Macho cat T O M
M. Water pipe H O O K A H
N. Consistent with one's obligations E T H I C A L L Y
O. Soup additive N O O D L E S
P. Big story E P I C
Q. Sift; sort; separate W I N N O W
R. Widespread; uncontained R A M P A N T
S. Stare at E Y E
T. Whale food P L A N K T O N
U. Composed U N F A Z E D
V. Night fliers B A T S
W. Onion cousin L E E K
X. Crude remark or gesture I N D E L I C A C Y
Y. Nerve C H E E K

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It is tough – make that virtually impossible – to keep up with economic research in public policy. To make it a little easier, we're offering a heads-up on what's new and relevant. Advice from readers (or authors) in the form of e-mail is always welcome.

WHOSE WELFARE?

In the 1980's, liberals argued that any welfare reform measure that would drive millions of unskilled indigents onto the labor market would have draconian consequences. Not only would such a measure cause suffering among welfare recipients, they argued, it would push large numbers of the working poor onto the unemployment lines and drive down the wages of those lucky enough to remain employed. By the time welfare reform was the law of the land, however, the Great American Job Machine was already in high gear and little, if any, of the hypothesized displacement effect has been reflected in the numbers.

What happens next? Tim Bartik an economist at the Upjohn Institute in Michigan, forecasts that by the year 2005, sanctions on long-term welfare recipients will have increased the American labor force by something less than 2 million. That represents just a bit more than 1 percent of the total labor force over a decade – hardly enough to be noticeable in the big picture. But some groups – notably women with few skills – are not apt to escape scot-free. Bartik estimates that in 1997, unemployment among female heads of households would have been a half percentage point lower and wages for that group 2.5 percent higher if welfare reform had not gone into effect.

Not a big deal – unless you happen to be a woman without much education trying to raise a family on one wage. [*"Displacement and Wage Effects of Welfare reform" Upjohn Institute for Employment Research Working Paper, Jan. 1999. Download from www.upjohninst.org.*]

WATER, WATER EVERYWHERE...

It's almost conventional wisdom that, in an age of surfeit of raw materials and falling commodity prices, water will emerge as the key scarce resource for economic development. Maybe. Then again, maybe not. Once water is treated like other marketable commodities and is used efficiently, scarcity often gives way to glut. Indeed, while Canadians mutter grimly about water imperialism from the south and Turkey builds its Middle East policy around water issues, freer markets may make their fears look a bit silly.

A World Bank survey of

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water issues in 11 countries by A. Maria Saleth and Ariel Dinar probably won't surprise anyone who has been following the subject closely. It does document, however, the quiet sea change in attitudes, as countries begin to treat water like other useful commodities. Perhaps the most striking developments have taken place in Israel, which has increased the productivity of water in agriculture by 250 percent since reforms were enacted in 1987, and farms began to recycle expensive fresh water. Not surprisingly, the country surveyed with the furthest to go is India, arguably the world's last important bastion of socialism. [*"Water Challenge and Institutional Response: A Cross-country Perspective." World Bank Working Paper 2045, Feb. 1999. Download from www.worldbank.org.*]

Too Few Toxins?

The "Superfund" toxic waste site clean-up program, begun in 1986, remains one of the Environmental Protection Agency's most popular programs. Tidying up the mess left by assorted individuals, corporations and local governments – and then sticking those responsible with as much of the cost as possible – seems like a no-brainer.

There's a catch, though. Well, lots of catches. But the one of most interest to James Hamilton of Duke and Kip Viscusi of Harvard's Kennedy School, is the failure to apply some reasonable cost-benefit test to clean-up efforts. For a sample of 150 Superfund sites examined, they found that in the great majority of cases, the Government spent more than a $100 million to avoid one cancer death.

Is $100 million too much to save a life? That's a hoary debate, with economists generally arguing that safety resources are limited and that spending a lot in one area means less to spend elsewhere. It's worth noting, however, that $100 million is 10 to 50 times more than what people seem to value their lives when they are given the chance to reduce risk – say, by accepting lower wages to avoid riskier jobs.

The more important punch line here is that relatively small sums would save most of the lives potentially lost to exposure to toxins at Superfund sites. Uncle Sam has to pick his targets – and also has to settle for less-than-total cleanups where the last bit of poison is incredibly expensive to remove. [*"How Costly is 'Clean'? An Analysis of the Benefits and Costs of Superfund Site Remediations." Journal of Policy Analysis and Management. Winter 1999. For copies call 212-850-6645.*]

...AND NOT A DROP TO DRINK

Economists are the pushy imperialists of the social sciences, explaining the world in their own terms to whoever will listen. Phillip Cook of Duke University and Michael Moore of Fuqua School of Business at Duke fit nicely into the category with their latest work, a summary of what virtually all economists have to say about alcohol.

Among the research papers they summarize are estimates of the "external" costs of drinking, necessary for devising taxes that internalize these costs, and estimates of the demand for alcohol, necessary for calculating the impact of restrictive measures on the level of alcohol consumption.

You say you're not inter-

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When Less is More

How much health care is enough? The debate that roared through the early 1990's has diminished to irritable chatter, if only because neither politicians nor the public could really get their hands around the deeply devisive issue.

These days, the health care debate seems to come down to how many days your friendly neighborhood H.M.O. must allow you to stay in the hospital after a limb is removed.

But David Cutler of Harvard and Elizabeth Richardson of the National Bureau of Economic Research aren't letting go of the big question. The only rational way to decide how much to spend on health care, they say, is to compare the costs and benefits. To this end they estimate something they call health capital – what good health is worth at each point in life – and then compare the likely change in health capital with the cost of a given medical procedure.

An exercise worthy of Mr. Spock, you say? Sure, but the authors do make one point that ought to convince practically anybody. Instead of asking the question of how big the overall medical budget should be, they argue, policymakers should ask how to get more bang for a buck by figuring which expenditures have the highest payoff in terms of increasing health capital. [*"Your Money and Your Life: The Value of Health and What Affects It." National Bureau of Economic Research Working Paper 6895, Jan. 1999. Download from www.nber.org.*]

ested? Wait until the lawyers who did in the tobacco lobby get hold of it. [*"Alcohol," prepared for the forthcoming "Handbook of Health Economics," but available as National Bureau of Economic Research Working Paper 6905, Jan. 1999. Downloadable from www.nber.org.*]

ECONOMIC IMPERIALISTS

For two decades economists have been lecturing environmental policymakers on the basics: the need to apply cost-benefit analysis to environmental issues; the efficiency of market-based solutions over environmental planning.

Believe it or not, says Robert Hahn, the director of the AEI-Brookings Joint Center for Regulatory Studies, the message has gotten through. Hahn's chronicles the rising influence of economics in environmental policy – in particular, the use of private incentives to achieve public goals.

But the going is tough. And Hahn argues that economists are going to have to rethink their disdain for political lobbying if they are to win the big battles down the road. [*"The Impact of Economics on Environmental Policy," AEI-Brookings Joint Center for Regulatory Studies working paper, Jan. 1999. Download from www.aei.brookings.org*]

WELCOME TO NORTH AMERICA

Canada's immigration policy, in striking contrast to that of the United States, gives strong preferences to individuals with marketable skills. A new assessment by David Green, an economist at the University of British Columbia, suggests that it has indeed paid off handsomely. He finds that immigrants are greatly over-

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represented in professions and under-represented in semi-skilled and unskilled labor markets in Canada. Equally interesting, immigrants are far more mobile occupationally, moving between occupations and up the labor market ladder.

This evidence only reinforces what commentators have been saying for a long time. Canada's preference system has apparently served the country well, attracting the best and brightest immigrants and discouraging those with little human capital, who are far less likely to assimilate rapidly.

Should the United States imitate its northern neighbor? Alas, United States immigration policy may be so politicized that rational debate over which applicants to admit and when may be beyond the country's capacities. [*"Immigrant Occupational Attainment: Assimilation and Mobility over Times," Journal of Labor Economics. Jan. 1999. For access, e-mail the journal at subscriptions@journals.uchicago.edu.*]

GLASS WALLS

With the end of most forms of legal workplace discrimination against women – and increased enforcement – it has been widely assumed that occupational choices would slowly converge. One place to track the trend is to look at the majors that college students choose. And these show that women are, indeed, moving from education to business majors in vast numbers.

The gender wall is not falling, however, between the "life sciences" on the one hand, and math, physics and engineering on the other, say Sarah Turner of the University of Virginia and William Bowen, the president of the Mellon Foundation in New York.

Why not? Turner and Bowen estimate that high school preparation, as crudely reflected in Scholastic Aptitude Test scores, explain less than half the statistical difference. The rest they attribute to cultural values and perceived labor market expectations – resilient differences in the way men and women look at the world.

"We do not see continuing movement toward gender neutrality in the skills (or credentials) that students take from college," they write. [*"Choice of Major: The Changing (Unchanging) Gender Gap." Industrial and Labor Relations Review. Jan. 1999. For abstract and subscriptions, www.ilr.cornell.edu/depts/ILRrev.*] M

—Peter Passell

Greater Fools

When is the stock market overpriced? When the world runs out of suckers who will pay more than the last set of suckers, say the cynics. Most economists, faced with the thorny question of factoring investor behavior into analyses of financial markets, throw up their hands. But not Robert Shiller of Yale , who has spent much of his career at the intersection of economics and behavioral psychology.

His latest effort, creating indices of financial bubble expectations and investor confidence, are based on a decade's worth of survey material. What to make of the indices is another matter, but plenty of otherwise sensible folks are tantalized by the prospect of being able to explain or predict what seem to be the least predictable events – the speculative bubble. [*"Measuring Bubble Expectations and Investor Confidence," National Bureau of Economic Research Working Paper 7008. March 1999. Download from www.nber.org.*]

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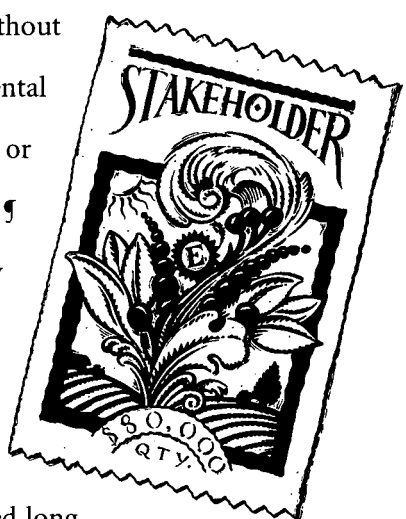
The Stakeholder Society

Bruce Ackerman and Ann Alstott offer a neo-liberal alternative to the welfare state.

ILLUSTRATIONS BY SCOTT WRIGHT

It's a lot harder to get worked up – or at least easier to feel sanguine – about economic inequality in America than it was a decade ago. Unemployment is near record lows, the black middle class is expanding, wages are rising and millions have left the welfare rolls without much evidence of serious hardship. Contrast that with continental Europe, which is staring at 20 percent youth unemployment, or Japan, which seems to be reinventing the Great Depression. ¶ But you still don't have to be a weatherman to tell which way the wind is blowing. Technology, international competition and the decline of unions have all conspired to drive a wedge between the financial prospects of the skilled and unskilled, while housing inflation and retirement entitlements negotiated long ago have widened the wealth cleavage between the young and the old. High-income



BY BRUCE ACKERMAN AND ANNE ALSTOTT

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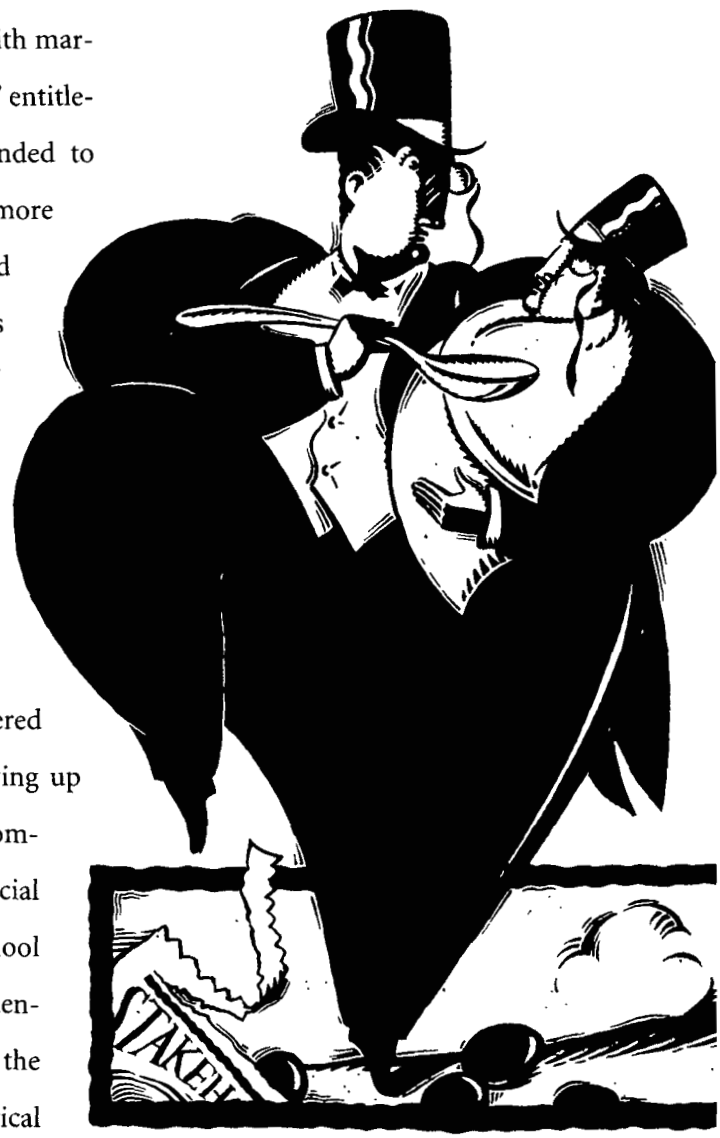
workers are marrying other high-income workers, creating a new meritocratic elite that will no doubt pass on the privileges of membership to their kids. "Winner-take-all" phenomena are concentrating success in fields ranging from law to basketball. ¶ Meanwhile, there seems to be little collective will to interfere with market-driven outcomes or old-folks' entitlements. Commutarian fixes intended to take the sting out of inequality – more spending on public parks and culture, public service mandates for the young – are deeply out of fashion. So, too, are policies designed to redistribute income through more progressive taxes or government wage subsidies. ¶ But Bruce Ackerman and Anne Alstott, liberals tempered by conservative times, aren't giving up on the idea that capitalism is compatible with older notions of social justice. And the two Yale Law School professors bring formidable credentials to the table. Ackerman is the author of a dozen books on political philosophy and public policy. Alstott earned her bones as an attorney in the U.S. Treasury's Office of Tax Policy. ¶ Check out this adapted excerpt from *The Stakeholder Society*, which has just been published by the Yale University Press.



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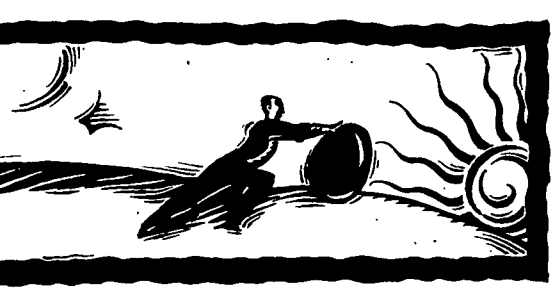
America has become a three-class society. 25 percent of its children now graduate from four-year colleges and move into the privileged class. Their increasing prosperity stands in sharp contrast to the grim picture of life at the bottom. The lowest 20 percent inhabit a world of low wages, dead-end jobs and high unemployment despite the economic boom.

And then there are those in the majority. Over the past quarter century, they have endured a long period of economic stagnation. Despite optimistic rhetoric from the right, economic growth has bypassed these forgotten Americans. The richest 20 percent have captured all of the growth in the nation's wealth since the early 1980's. While income trends have been somewhat less extreme, family income for the vast middle is only modestly higher than in 1973. Even treading water has been tough. Average real wages for men have declined by nearly 15 percent, and it is only the massive entry by women into the workplace that has taken up the slack.

Trickle-down economics has utterly failed. And it will continue to fail in the globalizing economy. The past is prologue: By 1995, the top 1 percent owned 38.5 percent of the nation's disposable wealth, up from 33.8 percent in 1983. During the 1990's, the share of total income earned by the top 20 percent has risen to its highest point since 1947.



Our politics has not caught up with this three-class reality. On the one hand, we heap large subsidies on the college-bound. On the other, we target the underclass with diminishing amounts of assistance. But we have done little to aid the vast middle. While the rich have been showered with tax breaks, the middle has been treated to a series of symbolic gestures signifying nothing. The 1997 "middle class tax cut" hid a darker agenda. The average family took home an extra $350 from new tax credits for children and education, but the rich gained thousands of dollars from the capital gains tax cut and other goodies.

The result is simmering resentment and a ready reception for the protectionist nostrums of Ross Perot and Pat Buchanan. The current boom will hold these economic nationalists in check for a while. But it is past time to search for a more constructive response to economic inequality. How can we use the benefits of globalization to insure that every American gets a fair start in life?

Our plan seeks justice by rooting it in capitalism's pre-eminent value: the importance of private property. It points the way to a society that is freer, more democratic and more productive. Bear with us, and you will see how a single innovation once proposed by Tom Paine can achieve what a thousand lesser policies have failed to accomplish.

Our basic proposal is straightforward. As

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young Americans rise to maturity, they should claim a stake of $80,000 as part of their birthright as citizens. This stake should be financed by an annual wealth tax, equal to 2 percent of every individual's wealth in excess of $80,000. The tie between wealth holding and stake-holding expresses a fundamental social responsibility. Every American has an obligation to contribute to a fair starting point for all.

Stakeholders may use their money for any purpose they see fit: to start a business or pay for more education, to buy a house or raise a family or save for the future. But they must take responsibility for their choices. Their triumphs and blunders are their own.

At the end of their lives, stakeholders have a special responsibility. Since the $80,000 was central in starting them off in life, it is only fair for them to repay it at death if this is financially possible. The stake-holding fund, in short, is enriched each year by the ongoing contributions of property owners and by a final payback at death.

There are many possible variations on the stake-holding theme. But we have said enough to suggest its broad political appeal. How many young adults start off life with $80,000? How many parents can afford to give their children the head start that this implies?

Stake-holding liberates college graduates from the burdens of debt, often with something to spare. It offers unprecedented opportunities for the tens of millions who don't go to college and have often been shortchanged by high school education. For the first time, they will confront the labor market with a certain sense of security. The stake will give them the independence to choose where to live, whether to marry and how to train for economic opportunity. Some will fail. But fewer than today.

We should, of course, structure the program to maximize the successes. For starters, no stakeholder should be allowed free use of his $80,000 without completing high school and passing a state or national qualifying examination. High-school dropouts would have their stakes held in trust and would have access only to the annually accruing interest. Since only three-quarters of Americans have high school degrees by the age of 21, this single requirement will prevent massive "stake blowing" by those least capable of handling adult responsibilities. It will also provide a beacon of hope to kids locked in rural poverty or urban ghettos. Stay in school and graduate, and you will not be forgotten. You will get a solid chance to live out the American dream of economic independence.

Timing is also crucial. High school graduates should get immediate access to their money if they want to spend their $80,000 on college. But those choosing other paths should be obliged to learn a few lessons in the school of hard knocks before they can get their stakes – in $20,000 annual payments between the ages of 21 and 24.

The result will change the way young people think about themselves, their options and their obligations to society. Begin with the college-bound. Poor kids confront hardships

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Joe Sixpack is every bit as much of an American as Joe College. And for the first time, his claim to equal citizenship will be treated with genuine respect.

unknown to their better-off peers – juggling schoolwork and jobs in ways that easily overwhelm self-confidence. The endless rounds of scholarship applications and intermittent failures to pay tuition take a toll by themselves. Statistics confirm that students in two-year colleges are even harder-pressed: A much higher percentage live at home, hold jobs and work more hours. It should be no surprise, then, that lower-class kids are much more likely to delay enrollment and less likely to earn degrees than their richer peers. They are also more likely to attend two-year institutions, rather than four-year schools. For this large group, stake-holding would work a genuine revolution. It would allow college-bound students to focus their energies on academic work and compete with their peers on more equal terms.

No less important, stake-holding would inaugurate a new era of healthy competition in higher education. While colleges might try to raise tuition, they would face countervailing market pressures to keep costs low. Every student would enter the market with significant resources and an incentive to shop carefully. No longer would state universities or community colleges have a captive pool of low-income students without other options. These people could now choose a school in another community or across the country or even overseas.

This option will be especially valuable to people interested in two-year degrees. At present, two-year colleges provide much smaller subsidies to their students than do more traditional universities. But under the new system, students at two-year colleges will have the same buying power as their more academically inclined age mates. To be sure, they will be utterly unwilling to spend their entire $80,000 on a couple of years of post-high school education. But their stakes will create new incentives for serious programs directed at their distinctive concerns. Over time, two-year colleges will emerge from the shadow of their bigger brothers and build their students' skills and self-confidence with increasing imagination and vigor.

We have left the best for last. Consider the millions who decide that college – even a two-year college – isn't for them. These are today's forgotten Americans. Many of them have already been denied the decent high school education that should be every citizen's birthright. Now they are tossed into the marketplace unaided, while their upwardly mobile peers are given federal scholarships and state-subsidized tuition.

This is wrong. Joe Sixpack is every bit as much of an American as Joe College. And for the first time, his claim to equal citizenship will be treated with genuine respect. Since these high-school graduates are not going to college, they will have to wait until their early 20's to gain access to their stakes. Indeed, some may want to require young adults to wait until 25 or so before they get any of their money. We would be happy to compromise so long as our basic principle remains intact.

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The decision to go to college should not be required for an American to gain the country's support for the pursuit of happiness. All Americans have a fundamental right to start off as adults with a fair chance at making a decent life for themselves.

For all our precautions, some will fail to make good use of their stakes and in ways they will bitterly regret. But the predictable failures of some should not deprive millions of others of their chances to pursue happiness. Each individual citizen has a right to a fair share of the patrimony left by preceding generations. This right should not be contingent on how others use or misuse their stakes.

Some poor Americans do face multiple social problems – inadequate education, drug or alcohol abuse, a propensity to violence – that leave them ill-equipped to handle financial responsibility for their stakes. Despite pervasive media images, the size of the so-called "underclass" is quite tiny – less than 4 percent of the population. And most of these people would be excluded from full control of their stakes by the requirement of high-school graduation.

We refuse to allow trendy talk of "underclass" pathologies to divert our attention from the central problem posed by our emerging three-class society. Quite simply, there are tens of millions of ordinary Americans who are perfectly capable of responsible decision making in a stake-holding society, but who are now becoming the forgotten citizens of our globalizing economy. We should confront this problem now before the gap widens to Latin American proportions.

In our many conversations on the subject, somebody invariably suggests the wisdom of restricting the stake to a limited set of praiseworthy purposes – requiring each citizen to gain bureaucratic approval before spending down his $80,000. Won't this allow us to redistribute wealth and make sure the money is spent well?

This question bears the mark of the bureaucratic mindset that has haunted so much policy making in the 20th century. Our goal is to transcend the welfare state mentality, not transform stake-holding into another exercise in paternalistic social engineering. The point of stake-holding is to liberate each citizen from government, not to create an excuse for a vast new bureaucracy intervening in our lives. To be sure, the construction industry, the university sector and the brokerage houses would prefer a plan that limited stakeholders' choices to home buying, education or investment. But if stakeholders want advice, they can buy it on the market. If people in their 20's can't be treated as adults, when will they be old enough?

We do not deny the need for a social safety net for Americans who make particularly bad choices. But this is not our primary focus. We are concerned with providing a fair opportunity for success for all Americans and not only those lucky enough to be born to parents of the privileged class. It is one thing to make a mess out of your life, quite another to never have had a fair chance.

Indeed, the real problem with our program is that it does not go far enough to redeem America's promise of an equal opportunity society. Doesn't the $80,000 stake come too late for all those who have been shortchanged as children?

While we certainly favor more spending on Head Start and the like, we are skeptical of the egalitarian potential of enormous new investments in primary and secondary education. So long as suburbs can insulate themselves from central cities, there is only so much that money alone can accomplish. And the upper classes have proved themselves over the years

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A Profile in Freedom

To help readers imagine what stake-holding might mean to young people, we offer a file of our own devising. Bill and Brenda are fictional, but their situations represent reality for millions of Americans in the 20th through 40th percentile of income distribution.

Bill and Brenda are a married couple in their mid-20's. Like 32 percent of their contemporaries, they graduated from high school but did not go on to college. Their working-class high school wasn't particularly inspiring, and they weren't inclined to see college as the key to their dreams. Instead, they found work similar to that of other young high school graduates.

Bill has had a series of jobs as a construction laborer. When construction slows, he often works as a clerk in a hardware store. Bill's income varies, since he sometimes spends months unemployed. In a good year, he can make as much as $20,000, but in a bad year he earns very little.

Brenda works as a home health aide. She receives assignments through an agency and mostly serves as a companion to elderly clients. She helps them with the tasks of daily living that they can no longer handle themselves. A typical assignment might last from a few weeks to six months, and although the work is exhausting and sometimes depressing, she does earn $8 an hour – better than the $6 or so she might make as a grocery cashier or fast-food worker. The work is pretty steady, although there are occasional periods of down time between assignments. She routinely earns $15,000 a year.

When they are not working, Bill and Brenda spend their time in church activities, hobbies (Bill is a talented amateur auto mechanic who collects of old cars and fixes them up) and taking care of their son, Peter, who is 4. Until now, Bill's mother has been minding Peter while his parents are at work. But Grandma's arthritis is worsening, and she is having a hard time keeping up with an active grandson. Bill and Brenda are worried about how they will afford tuition at a day-care center.

Bill and Brenda save money by living in a rented apartment in a rundown neighborhood. But their family is quickly outgrowing the two-bedroom unit, and they would like to buy a house, although they haven't saved much for a down payment, and they fear that their income is too irregular to qualify them for a mortgage.

They are also worried about Peter's education. They can tell that he is extremely bright, and they want him to have the best. They would like to put Peter in an excellent private preschool this year, but the tuition is expensive. Over the longer term the best local option is parochial school, which also costs something. Or they could move to a better neighborhood with better public schools – but "good" neighborhoods have few apartments.

Money is a constant problem. In lean times, it is sometimes a challenge to meet the rent and to pay for heat, food and doctor's visits. (Brenda has health insurance for herself through her agency, but the cost of family coverage is too high.) Even in good times, they clip grocery coupons, drive old cars and buy clothes at Wal-Mart.

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To this point, we have said nothing about the stake. But now assume that stake-holding became a reality and that Bill and Brenda had each received $80,000. How would their choices change?

Let's assume that Bill and Brenda have invested their money conservatively. By their mid-20's, they have a principal balance of $160,000 and are earning about $8,000 a year in interest, which they are spending for furniture, car repairs and living expenses during hard times. Just this year, they invaded their stake and spent an extra $10,000 to cover costs during one of Bill's longer layoffs. The decision caused them great anxiety. They know that their remaining $150,000 offers a lifetime opportunity – but what to make of it?

Bill would like to get out of construction and into a more secure and better-paying job. He has tried to get work as an auto mechanic, but employers tell him he needs formal training. So one option is for Bill to enroll in a training course and apprentice for a year or two. Another is for Brenda to go back to school. In two years at the community college, she could earn an associate's degree in nursing and qualify for a higher-status job with better pay. Their stakes would allow Bill and Brenda to pay tuition and living expenses while one of them is in school. And over the long term, a better job for Bill or Brenda would mean extra security for the family.

There are other options. Unemployment is a frequent reality for Bill. Just this year, when the construction industry slumped, the stake was a godsend. Without it, the family would have had to make ends meet solely on Brenda's income and a modest unemployment check. Having that cushion may also allow Brenda and Bill to take some time for their family, too. They would like a second child, and the stake would make it possible for Brenda to take a few months' unpaid maternity leave.

Buying a small house is another possibility. Their stakes would allow them to put a sizable down payment on a modest house, with a remaining mortgage that they could afford. And moving to a better neighborhood would insure Peter a higher-quality education. Peter's care is another issue. Their stakes could help them buy day care for their son and send him to a decent preschool.

Brenda's father is urging the young couple to take another route – to save all their money and avoid spending any even during hard times. He warns, "You never know what life holds" and reminds the pair that they have many long years to go until retirement.

Of course, Bill and Brenda cannot do all of these things at once – even $150,000 will only go so far. They could take Brenda's dad's advice and bank their money as a rainy day fund. They could continue to spend a couple of thousand here and there – maternity leave for Brenda, school for Peter, extra money when Bill is out of work. Or they could take the leap and make a bigger investment — a house or a training program that might have a major impact on their security, but at the cost of depleting their stake.

We cannot predict which choices they would make, much less how their decisions turn out. We do believe the vast majority of Brendas and Bills would have more self-confidence and more real security. But even if they failed, they would have had the taste of real freedom to make their own decisions about how best to live their lives. M

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adept in channeling federal aid for the disadvantaged into their own local school systems. Worse yet, school decentralization and privatization seem to be the order of the day – rather than a movement toward metropolitan-wide school systems and greater national efforts to provide poorer regions of the country with greater educational resources.

By contrast, it would be relatively easy to realize the goals of a stakeholder society. To a very large degree, the institutional infrastructure is already in place. We already have an I.R.S. and a Social Security Administration. Although it is fashionable to denigrate these "bureaucracies," both agencies are full of competent people whose tasks might easily be broadened to encompass the jobs of identifying eligible stakeholders and paying out benefits. Unlike a comparable educational reform, stake-holding will not require a massive reorganization of the existing institutional framework. It builds on what we already have.

Americans could, in relatively short order, actually make the great step toward equality of opportunity that stake-holding makes possible. This breakthrough, in turn, would give the lie to neo-conservative banalities about the inevitability of government failure. Having established that Americans can succeed in redeeming their fundamental ideals by inaugurating stake-holding, many other seemingly impossible initiatives may seem within our grasp.

Of course, real freedom and equal opportunity don't come cheaply. Using conservative assumptions, the annual cost of stake-holding today would be about $255 billion. This is a big number, but we have made comparable commitments in the past: Would America have been a better place after the Second World War without the G.I. Bill of Rights? At that time, wealthy taxpayers were a lot poorer than they are today and they were paying far heavier taxes – yet they did not seek to evade their obligation to give the rising generation a fair start in adult life.

The G.I. Bill represented the payment of a debt for the sacrifices that our soldiers made during the war. Today the ties that bind older to younger are less obvious – but no less important. Our society demands countless small acts of voluntary cooperation, as well as many larger personal sacrifices. If members of the younger generation are denied a fair start, how can the rest of us expect them to reciprocate as the need requires?

While the rich have been showered with tax breaks, the middle has been treated to a series of symbolic gestures signifying nothing.

For the rest of their lives, stakeholders will consider how their $80,000 contributed to their pursuit of happiness – and at the same time reflect on their good fortune in enjoying this precious right of economic citizenship. Except for the most hardened cynics, this will lead to a deep and sustaining loyalty to the country that made stake-holding a concrete reality. Rather than dismissing the Declaration of Independence as boastful words, stakeholders will hear in Jefferson's proud phrases a description of their own lives, and seek to repay their own debt by passing on their great heritage to the future.

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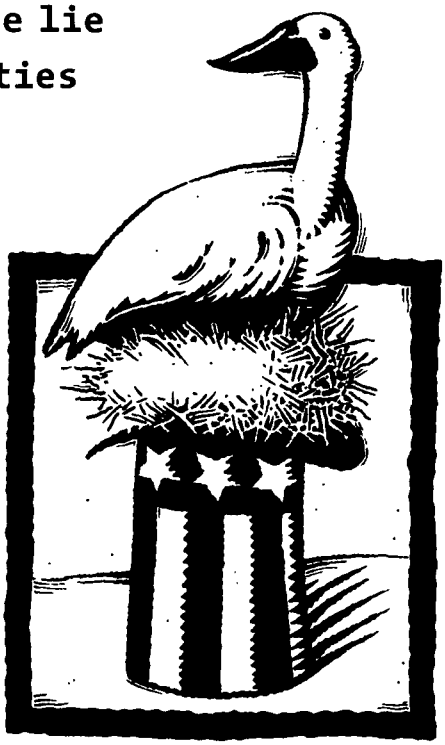
There are many ways to raise the needed money, but we believe the best is an annual tax of 2 percent levied on each individual's wealth in excess of $80,000. At present, the wealth distribution is so skewed that 60 percent of all American households would be exempt from the new tax; the next 20 percent would pay an average of $1,100 a year; and the top 20 percent would pay the lion's share.

This strikes us as entirely fair. Since wealth is correlated with age, Americans over the age of 50 will bear the brunt of our tax. But it is precisely these people who have participated fully in the great post-war economic boom. The wealthy man or woman who is 60 in the year 2000 was born in 1940 – just in time to avoid the agonies of the Great Depression and the Second World War, but just in time to reap the harvest. Graduating from college in the early 1960's, the typical up-and-comer was in a perfect position to take advantage of the rich array of opportunities made possible by America's rise to world power. The best universities, the most advanced companies, the biggest pool of capital – all of these were available for Americans who seized the moment. To be sure, nobody could become wealthy without some combination of effort, insight and luck. But it would be blind for any 60-year-old to ignore the role played by the simple fact that he or she was an American in an American age – and thereby gained the enormous advantages created at great sacrifice by his parents' generation. Given this generational advantage, it is especially appropriate to ask this group of elder Americans to make a sacrifice to sustain the Republic's political and economic equilibrium.

We are calling upon older Americans to remember that they themselves were the beneficiaries of similar acts of statesmanship by earlier generations. During the New Deal and Great Society, Americans recognized that the elderly as a group was particularly threatened by the inegalitarian operation of market forces. By responding with Social Security and Medicare, our predecessors insured a decent life for millions today. Is it not time, then, for the elder generation to reciprocate when the market threatens to undermine the promise of economic opportunity for millions of younger Americans?

This commitment should not come at the cost of retirees who depend on their monthly

Stakeholding would give the lie to neo-conservative banalities about the inevitability of government failure.



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Social Security checks. Rather than leading a raid on Social Security revenues, we simply urge prosperous older Americans to recognize the moral claim of younger Americans who will otherwise live out lives of quiet despair.

Or not so quiet despair. After all, the prison population has soared over the last quarter century. About 100 Americans in every 100,000 were in the nation's prisons in 1975; the number is now about 400 – and more than 600 when the short-term jail population is included. Young males and, increasingly, females are the prime targets for prison – men and women who might find it within themselves to take a different path in a stake-holding society. If inequality increases over the next century, are we really prepared to lock up more young Americans who react with rage at a system that has never delivered on its promises to them? If those with the greatest stake in the system do not take heed, who is supposed to?

It is time for the wealthy to accept stakeholding as part of the social compact. While wealth taxes are unfamiliar in America, they are a fixture of public finance in most other industrialized nations. Of course, every new tax generates the same old cry that it will kill the economy. Rich people are always happy to tell you the story of the goose that lays golden eggs. But is it just a fairy tale?

Not only has our economy boomed and busted under very different levels of taxation. Recent empirical research suggests that the link between tax rates and growth is far weaker than implied by the prevailing political rhetoric. Moreover, stake-holding will itself unleash the energies of millions of youthful entrepreneurs – while many will fail, others will succeed in ways that will enrich us all.

Two hundred years ago, Tom Paine surveyed the revolutionary world he helped to create and sensed something missing: "A revolution in the state of civilization is the necessary companion of revolutions in the system of government." This could be accomplished, he was convinced, only through stake-holding. Every citizen, Paine insisted, had a right to a stake of 15 pounds sterling "when arrived at the age of 21 years." In a remarkable gesture for the 18th century, Paine argued that this expanded stake should go to every man and woman. Regardless of his or her claims on private wealth, each should be accorded an economic stake in the commonwealth.

Tom Paine was not alone. Our leading founders acknowledged a deep relationship between property and citizenship. When Madison viewed "the merits alone," it was clear to him that "the freeholders of the country would be the safest depositories of republican liberty" and that the propertyless should be excluded from suffrage. Standing before the Constitutional Convention, he did not conceal his anxiety as he glimpsed the dread day when the "great majority of the people will not only be without landed, but any other sort of, property."

But in 1787, this grim prospect could be deferred to the remote future. The founders treated the problem of lack of property in the way they dealt with the curse of slavery. They did not seek a definitive solution, leaving it to some later generation to confront the crisis when it became acute.

This seemed sensible enough. A vast frontier beckoned to generations of yeomen farmers. So long as the government sold virgin land at low prices, the link between property and citizenship could be more or less preserved. But as the 19th century moved on, this Jeffersonian vision of a farmer republic became increasingly obsolete. By the time of the great Homestead Act of 1863, the statute's provision of free land on the frontier was

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already out of sync with the needs of the rising urban masses of the East. If the link between property and citizenship were to be sustained, providing free land would no longer suffice. With the closing of the frontier, something like Tom Paine's vision of stakeholding was required to guarantee each citizen a property interest in America.

But by then Paine's voice had become a muffled memory. The mainstream of reform was flowing in other directions: Populists, Progressives, New Dealers and the partisans of the Great Society sought to regain control over the market economy, but none moved in the direction of citizen stake-holding. Rather than broadening the property-owning base, their overriding aim was to regulate property more intensely in the public interest. But we think that the intellectual climate really is changing.

Nationalization of industry is on nobody's agenda anymore. People are slowly recognizing that capitalism is a Marxist label concealing the vast differences between economic systems built on private property and competitive markets – some bitterly unjust, others striving for a world worthy of a free and equal citizenry. It is time to stop dreaming about the abolition of private property and get to work creating a commonwealth in which all citizens are property owners.

This intuition has been behind some major initiatives attempted by leading politicians of our age. They have gained great followings through initiatives that bear a family resemblance to our proposal. When Margaret Thatcher became prime minister, 32 percent of all housing in England was publicly owned. Though bent on sweeping privatization, Thatcher refused to sell off these vast properties to big companies. She invited residents to buy their own homes at bargain rates. With a single stroke, she created a new class of property-owning citizens and won vast popularity in the process.

A more sweeping initiative took place in the Czech Republic in the aftermath of 1989. The prime minister, Vaclav Klaus, was confronting a much larger task than Thatcher's: the state sector contained 7,000 medium and large-scale enterprises, 25,000 to 35,000 smaller ones. How to distribute this legacy of Communism? Klaus saw his problem as an opportunity to create a vast new property-owning class.

Capitalism is a Marxist label concealing the vast differences between economic systems – some bitterly unjust, others striving for a world worthy of a free and equal citizenry.

The mechanism was the ingenious technique of "voucher privatization." Each Czech citizen was encouraged to subscribe to a book of vouchers that he or she could use to bid for shares in state companies as they were put on the auction block. An overwhelming majority – 8.5 million out of 10.5 million – took up Klaus's offer and claimed their fair shares of the nation's wealth as they moved into the free-market system. Klaus's creative program helped cement his position as the leading politician of the Czech Republic. More important, the broad involvement of citizen

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stakeholders legitimized the country's transition to liberal democracy.

Thatcher and Klaus conceived their initiatives as one-shot affairs. But the citizens of Alaska have made stake-holding a regular part of their political economy. Once again, the occasion was the distribution of a major public asset – in this case the revenues from North Slope oil. Rather than using it all for public expenditures, the Republican leadership designed a stake-holding scheme that is now distributing about a $1,000 a year to every Alaskan citizen. Once again, the system has become broadly popular, with politicians of both parties regularly pledging that they will not raid the symbolically named Permanent Fund.

There is no good reason to limit stake-holding to physical assets like housing or factories or oil. Americans have created other assets that are less material, but have even greater value. Most notably, the free enterprise system did not drop from thin air. It has emerged only as the result of a complex and ongoing scheme of social cooperation. The "free" market requires heavy public expenditures on police and courts and much else besides. But without billions of voluntary decisions by Americans to respect the rights of property in their daily lives, the system would collapse overnight. All Americans benefit from this cooperative activity – some much more than others. Those who benefit the most have a duty to share some of their wealth with fellow citizens whose cooperation they require to sustain the market system. This obligation is all the more exigent when the operation of the global market threatens to split the country more sharply into haves and have-nots.

This view gives our proposal a different ideological spin from those pioneered by Margaret Thatcher and Vaclav Klaus. Surely there will be some on the right who will blanch at the implications of our proposal. But we do hope that many others will come to see its justice. We expect a similar split on the left. Some will be deeply suspicious of liberating stake-holding assets from the grip of the regulatory state, leaving all citizens free to make their own decisions. Others will be more impressed by the justice of empowering all Americans to share in the pursuit of happiness.

Stake-holding also holds out the promise of political renewal. Nobody we've met has the slightest problem grasping the idea of $80,000 – or the possibility of funding the program by taxing wealth. Lots of people don't like our initiative, but at least they know what they disagree with – and this is absolutely essential for a rebirth of democratic politics in this country. Unless progressives come up with projects that are transparent to the common understanding, the politics of scandal will have no real competitor. The general public has no patience for a policy debate that speaks a technocratic language accessible only to people with advanced degrees.

If Beltway babble is the alternative, ordinary Americans will turn with relief to news of the latest personal indiscretion by leading politicos. Only a program like stake-holding can focus the public mind on the prospects for real change. It raises in a straightforward and concrete way the leading questions of our age: Is America more than a libertarian marketplace? Can we preserve a sense of ourselves as a nation of free and equal citizens?

THE STAKE IN CONTEXT

It is time to bring stake-holding down to earth – to consider the tough choices required to transform our idea into an operational reality. It would be foolish to explore every nook and cranny of programmatic detail. But a head-on

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confrontation with key issues will give real-world substance to stake-holding, allowing a better appreciation of its strengths and weaknesses. Reasonable people will disagree with our answers to particular questions.

This is all to the good, as long as these disputes do not defeat the entire project. There is a danger of this happening, but the only remedy is a sense of perspective – remembering to keep our eyes on the whole as we argue about each particular part.

Immigrant Stakeholders?

Imagine a 21-year-old English tourist arriving at Kennedy Airport, hailing a taxi for New York City and making his way directly to the closest stake-holding office. While nobody will have trouble denying the tourist a stake, it is easy to think of harder cases. How strong a connection to America should be required?

Begin with longtime resident aliens. As long as they decline to take the oath of citizenship, we see no reason to extend them rights of economic citizenship.

A harder question is whether all American citizens should qualify. There are two problem cases. The first involves people who make their claim based on the accidents of birth. Suppose that a French graduate student gives birth while studying at Yale in New Haven and shortly afterward returns with her child to Paris. A day before the boy turns 21, he takes the plane from Paris to New York to make his claim at the stake-holding office. Under the 14th Amendment, he qualifies as a citizen by birthright. Should he be entitled to take his $80,000 and return to Paris?

A second case involves citizens by naturalization. Our hypothetical immigrant arrives as a teen-ager and takes his oath of citizenship the day before he turns 21. He immediately proceeds to the stake-holding office to make his claim. Should it be accepted?

It is tempting to err on the side of generosity, but we urge restraint. Start with the naturalization case. In 1996, of the more than one million immigrants who took the oath of citizenship, 10 percent were under the age of 25. If extending a stake to all of them would lead American voters to support a more restrictive immigration policy, we confront a hard choice: Is it better to admit a smaller number of immigrants and grant them $80,000

Both stake-holding and the criminal law share a common foundation. As stakeholder you are responsible for your life plan, and if it involves criminality, you are justly held to account.

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apiece, or admit a larger number and deny them stakes?

Like it or not, political realities force us to take this tradeoff seriously. We believe that it is much more important to keep the door open than to provide stakes to the few who might manage to squeeze in. As a consequence, we would not allow the 21-year-old to naturalize and claim a stake. We would restrict this right to those with deeper roots in this country.

For naturalizing citizens, a residency requirement makes sense as part of a realistic effort to keep the doors open for future generations of immigrants. For birthright citizens, it makes sense to prevent cynical raids on the Treasury. It would be invidious – and probably unconstitutional – to impose different residency requirements for different classes of citizens. If an 11-year residency is demanded of naturalized Americans, it should apply to the rest of us as well.

The Stake as a Deterrent: Carrots and the Criminal Law

Traditionally, criminal law has treated young wrongdoers as if incarceration were the only alternative to less oppressive forms of control. But stake-holding provides another tool, with distinctive advantages and dangers.

With their stakes, youngsters will suddenly have something to lose other than their freedom. The criminal law of a stake-holding society can threaten them with the loss of some or all of their $80,000. To be sure, this threat will influence the actions of only those youngsters who can look ahead. And the younger they are, the less responsive they'll be to the threat. Thus it would be silly to punish a 12-year-old by declaring his stake forfeit. But this sanction would carry greater force for an 18-year-old.

It would also have a more general educative effect. Impoverished communities would be full of stories about good guys who stayed honest and were now claiming their $80,000, while others tossed away their stakes by dealing drugs.

But there are dangers in an overly enthusiastic embrace. It would be all too easy for politicians to brandish their new tool as a blunderbuss. Rather than using the withholding of stakes as a substitute for incarceration, demagogues might simply add forfeiture as an automatic consequence of every conviction. Worse yet, they might expand the list of felonies in order to deprive minors of their $80,000 when they would not think of imposing a comparable fine on older wrongdoers. The dangers of abuse are magnified by the notorious racial disparities in the administration of the criminal law. It would be tragic to allow stake-holding to become another monument to racial injustice.

Nonetheless, both stake-holding and the criminal law share a common foundation in liberal notions of individual responsibility. As a stakeholder, you are responsible for shaping your life plan, and if it involves criminality, you are justly held to account. There is nothing categorically wrong in using the stake to support the principles of responsibility at the core of the criminal law.

At the same time, we should not allow the criminal law to cheapen the meaning of stake-holding. It would be all too easy to treat the stake as if it weren't really the property of the young wrongdoer and to take away $30,000 or $40,000 for a trivial offense, explaining that a stake is a privilege, not a right. But the entire point of stake-holding is to move beyond the rhetoric of the welfare state.

First, stake-holding sanctions should be reserved for serious offenses and those where an economic deterrent seems particularly

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appropriate – trafficking in drugs, for example. Second, these penalties should generally serve as an alternative to prison. Third, stake-holding sanctions should come in graduated doses. Except in the most heinous cases, nobody should lose his entire stake for a single offense. Once a convict has lost all hope of getting any of his $80,000, the deterrent value of stake-holding has been exhausted. Finally, youthful offenders should be given a second chance to reclaim their stakes by keeping clear of crime for a substantial period.

Why $80,000?

We have thus far been speaking of the false promise of maturity that confronts the typical young adult in modern society: on one hand, she is held responsible for life-shaping decisions, but on the other, she lacks the economic resources to make them in a responsible way. In setting the size of the stake, we should keep this basic moral dilemma in mind.

The stake should be big enough to provide each citizen with a cushion against market shocks and to enable her to take a long-term perspective as she determines the most sensible ways of investing in herself, her family, her career and her community. This logic suggests that a small sum – say, $10,000 per person – is inadequate to the task, but how high should we go?

The comparison between Joe College and Joe Sixpack helps us set the standard. Eighty thousand dollars is enough to pay for four years of expenses at the average private college in the United States. This means that typical college-bound youngsters will be in a position to graduate debt-free (more or less) if they get good summer jobs or can rely on some parental support. Liberated from the crushing burden of debt, they will confront the future with a precious independence.

Four years at college will not magically eliminate the need for hard choices about career, family and the meaning of life. Nonetheless, the skills and self-understanding these students will gain will place them in a fair position to take responsibility for these choices. In a rough-and-ready way, a college education serves to redeem the promise of maturity in contemporary society.

But if this is so, $80,000 should also set the standard for the three out of four Americans who don't earn bachelor's degrees. As equal citizens, they too are entitled to confront their adult years with their heads held high while preparing themselves for the future as they see fit.

A NEW AGE OF FREEDOM

Stake-holding really does bring power back to the people. We do not need a host of experts to minister to ordinary Americans. Give citizens their stakes and let them inaugurate a new age of freedom.

This call can unify a badly fractured nation. Even many Americans in the top 20 percent may recognize its power. Do they really want their own children to live in gated communities locked away from the rest of American life?

The stakeholder society is no utopia. But it does provide an alternative to our current moral drift. Perhaps we will never fully realize the American dream of equal opportunity. But without that dream, this country will become a very ugly place. M

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A Nobel Roundtable

Douglass North, Merton Miller, Michael Milken, Gary Becker and Myron Scholes explain it all to you

As part of the Milken Institute's 1999 Global Conference, Michael Milken led a 90-minute, no subjects barred roundtable discussion with four recipients of the Nobel Memorial Prize in Economics. It has been edited for readability and, most of all, for space. A more comprehensive rendering can be found on the Milken Institute Web site (www.milken-inst.org). – Peter Passell

MICHAEL MILKEN: Good afternoon. We're happy to be with you today. The youngest member of this group is Myron Scholes. Myron, as most of you know, developed a new method to determine the value of financial derivatives, creating order out of apparent chaos and helping us to understand capital markets. He had this young man over here – Merton Miller – as one of his professors.

Our next-most-recent Nobel Laureate is Doug North. Doug was brilliant at a very young age and demonstrated it by deciding to further his education at my alma mater, the University of California at Berkeley. He is the leading economic historian of our group. Why do some countries become rich, while others remain poor? Why do some parts of the world flourish, while others don't?

Next is Gary Becker. He was an undergrad at Princeton and then received his Ph.D.

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from the University of Chicago. Crime and punishment; the development and accumulation of human capital; the structure of families – his unique approach to these subjects links economic analysis to social issues.

Our senior Laureate is Merton Miller. Merton graduated from Harvard in 1944, then went on to Johns Hopkins. Financial innovations, marketplace volatility, countries' financial structure – all have been Merton's interests in an illustrious career.

Let us begin our discussion today with a simple question: Can you have complex financial technology without an underpinning of human capital or social capital or physical assets?

MERTON MILLER: Financial technology is something that's happening in the United States. I'm afraid that elsewhere – with the exception of Europe – there just are not the preconditions for developing technology.

MILKEN: What's held it back?

MILLER: We took 200 years to get where we are.

MILKEN: Aren't China and India a lot older than 200 years?

MILLER: Yes, but China hit the wall around 1640. Until then, China was the leading nation in the world.

DOUGLASS NORTH: There are competing theories for why China declined. You had a centralized bureaucracy; you didn't have competition among economic units…

MILKEN: Well, we think of the United States as a young nation. Why have financial technologies developed here, Myron?

MYRON SCHOLES: I think it has to do with human capital. When people focus on institutions, they're missing the mark. In the United States, in particular, we've been able to use human capital to innovate because we've asked the right questions. How can we make profits by having more efficient transaction systems? How can we make profits by sharing risk and providing diversification?

GARY BECKER: I'd like to come back to the more general theme of the relation between human capital, incentives, social capital and the like.

Look at the Communist regimes. The share of income they spent on education was greater than in other countries of comparable development. Nevertheless, they had dismal economic performances. We not only had the human capital, we gave people the incentives to utilize it effectively.

The Russians got low rates of return on human capital because they did not have a market – an environment that induced people to use human capital effectively.

MILKEN: To summarize: Countries' development has been a function of their human capital in conjunction with their social capital, the rule of law and other such factors.

MILLER: It's the human capital, plus the incentive to utilize it properly. The attitude of the Chinese is "we want to get rich and we are going to utilize whatever techniques we need to do it." In Russia, I don't sense that attitude at all. This is why I think China is going to make it, and I'm really very hesitant about whether Russia will.

BECKER: I'm going to take a different cut at the problem. There's always been human capital. But its significance has grown, and presumably will continue to grow. We're a knowledge-based economy. However, you cannot have effective human capital unless you have the right economic system – one that gives the entrepreneurs, technicians and investors incentives to bring together the human and physical capital.

MILKEN: Africa and Asia make up 60 percent of the world's land mass. But measuring the world's continents by G.D.P., we see how much larger North America and Europe are. Could it have been different?

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NORTH: What's crucial here were the institutions that were carried over from Spain and Portugal to Latin America on the one hand, and from Britain to North America on the other. The Spanish were interested in treasure, and so they instituted regimes that would maximize the revenue derived from gold and silver. They did not provide self-government in Latin America, nor did they create property rights.

Contrast that with North America. We had representative assemblies when we were colonies; we developed efficient property rights. The result was a foundation for thriving economies.

BECKER: Doug, I think you're giving too much support to the view that the problems in South America and Africa were created by colonialists. Colonialists left a legacy, but the problems have largely been self-generated. The Africans created governments that were basically socialistic, following the Russian model. And they failed dismally.

MILKEN: If the Soviet Union had not existed, would post-World War II history have been different in Africa?

BECKER: When Khrushchev said, "We will bury you," he didn't mean, "We're going to bury you with missiles." He meant, "Our system is going to bury the United States system."

Impressed, the new governments in Africa placed their bets on the Soviet model. So I do believe that if we had not had the Soviet experiment in Communism, Africa might well have taken a different model.

NORTH: We can change what happens, but history does constrain choices. In the past dozen years, I've been playing God as an adviser to various countries...

MILKEN: How is that job?

NORTH: It's not all it's cracked up to be.

AUDIENCE VOICE: Does it pay?

NORTH: Not very well. But it does take a lot of the hubris out of us economists.

If you're really going to improve things, then you must learn where you can make a difference. So yes, Michael, we can change the way the game's played – but only if we understand the way change takes place.

Merton Miller and Myron Scholes double-team Michael Milken.

MILKEN: Let's look at another topic. We're living in a developed world that is aging and an undeveloped world that is getting younger. In the last 30 years, the United States added just 70 million people, and partly through immigration. By contrast, Mexico went from 53 million to 102 million. Brazil went from 96 million to 174 million. What is the world going to be like as people over 65 focus on

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retirement and the younger look elsewhere?

MILLER: I suppose we could go to Florida and find out. One thing I do know: It's hard to get expenditures for schools.

SCHOLES: You don't know the innovations that are going to occur, or how they will change the calculus. We haven't talked about changes in education; we haven't talked about how communications and transportation costs are falling; we haven't talked about the Internet.

BECKER: The main difference between the developed and the developing worlds is fertility. Now, one thing we do know is that as countries develop, birth rates go down and families substitute the quality of children for the quantity. In 1960, for example, the average family in Taiwan was producing four or five children. Today, the number produced by a typical Taiwanese woman is about 1.5.

So I think we can make the following conditional prediction: If India and other-less developed parts of the world experience significant development, they will lower their birth rates. And they will invest a lot more in each of child.

MILKEN: So as per-capita income goes up, birth rates will come down?

BECKER: Per-capita income and education both matter, particularly for women. Countries that lag in their education of women generally have lagged in the rate at which fertility comes down.

MILKEN: I remember one of our programs in the inner cities of Detroit. I was interviewing one of our Milken Family Foundation education-award winners and she told me that the best form of contraception was opportunity, hope and education.

MILLER: The other side of that coin is that we are going to have an aging population.

MILKEN: Have we ever had a situation before where countries or regions have been dominated by older people?

AUDIENCE VOICE: Wartime, when the young people have been killed off.

NORTH: We're changing the way human beings are living. It's not just a problem of financing Social Security. It's also about adjusting to changes in the productivity of older people.

BECKER: As we get older, none of us thinks it's all bad that we're living longer. But I think all societies are facing two problems: financing Social Security and medical care.

No matter how you approach social security – whether you stick with the pay-as-you-go systems or go with some other system – you have to manage the financial problem. I certainly favor a privatized system. But there's an even more important problem: How are we going to finance the medical care of this aging but healthy population?

SCHOLES: Promises have been made by governments to retirees that could potentially lead to tremendous financial difficulties for Japan, some European countries and even for the United States. Either we'll have to tax the young or abrogate the implicit contracts with the elderly. If people understand this dilemma, it may affect the amount of time they choose to stay in the work force.

BECKER: Social security in Europe and the United States is inducing people healthy enough to work to work to leave the labor force. There's scarcely anybody over 60 in Europe who works.

MILKEN: The issue I relate to is unfunded pension liabilities in the 1980's. General Motors let us know that their balance sheet was accurate – except they had not recorded $60 billion in unfunded liabilities. The company eventually wrote off some $30 billion.

Private pensions here have been taken care of by the tremendous growth of equity markets. A large part of the earnings of companies with large pension funds has come from

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stock market performance.

Companies formed in the last 20 years generally don't have pension funds. They're not going to have their earnings positively or negatively affected by how the markets do. But we're talking here about entire economies with people retiring with pensions, some of them indexed to inflation. How could we even begin to address this problem?

MILLER: Anticipate it and don't let it happen. But that's not a very popular stance.

MILKEN: We should also point out that when social security was created, life expectancy was lower than the retirement age. It wasn't really much of a liability.

MILLER: The answer is privatization. But the transition is going to be intricate. It's always easier not to give a dog a bone than to take a bone away from a dog that already has one.

MILKEN: Well, the private problem was solved with higher rates of return on pension assets.

SCHOLES: And the way pension benefits are determined was also changed, moving from "defined benefit" programs to "defined contribution" or 401(k) programs. Responsibilities for under-performance were passed from the corporation to the individual participants.

MILLER: As Michael mentioned, so much has been dependent on the unusual stock market performance. Can that be counted on for the future? I am skeptical.

MILKEN: If you were in financial markets from '65 to '82 or '83, you got a 1 or 2 percent rate of return and you believed in debt. Since '83 we have substantially higher rates of return – in the mid- to high-teens – and so we believe in the stock market.

When you say "identify the social security problem early," doesn't this problem already exist throughout the world? Doesn't it exist in the form of trillions of dollars of unfunded pension liabilities?

SCHOLES: It's a liability of the Government, the way it was a liability of the corporations. The question is how you value that liability. It's a promise to pay, akin to a high-yield bond. It doesn't mean that's what the expected payment is; there are going to be defaults.

BECKER: I think we should distinguish between pension funds, private companies and Government social security.

Developing countries are in a very fortunate position with regard to the latter because they have not yet gone down the pay-as-you-go road. You can look at China, which is now debating what type of social security to have, or India, which doesn't have social security at all. They can make the relatively easy choice to go to individual-account systems, where people would have freedom to accumulate assets managed by private companies.

It's harder for the United States and Europe. I still think we should go to a privatized, individual-account system, which would greatly reduce the role of politics in

Douglass North, meet Gary Becker.

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questions of retirement age, portfolio restrictions and the like. But there's no getting away from the fact that there will be a transition funded by some form of double taxation. The Chileans managed with big budget surpluses, which they used to finance this transition. We could do it now with our surpluses; I think it's the right time to do it.

MILKEN: I'd like to move on. The world is not homogeneous. In fact, if we look at the United States, we realize that even in the area where we've seen an unbelievable explosion of human capital – the corridor between Berkeley and Stanford – we still find Oakland. In the Oakland schools, only 23 percent of the kids can read at the national average! We have the world's highest per-capita income, yet we have undeveloped in our midst.

BECKER: Poverty is relative. There's no doubt, though, we have a significant number of children growing up in families with limited opportunities. We've had this great growth in broken families, only just now tapering off. Second, we're giving a low-quality public school education to poorer children.

I think two things can be done. One, already implemented, is to discourage women from making a career out of welfare. Since 1993, there's been a 40 percent decline in the number of families receiving welfare. So welfare reform had a very significant effect – and a beneficial one.

The public school problem is more difficult because of the public education monopoly. Competition works as well in teaching as it does in producing steel, newspapers or any other product. If we went to a competitive, voucher-based system, the main beneficiaries would not be the rich or the middle classes, but the poor.

MILKEN: Gary, you've focused on K-12 education. But in sheer numbers, our greater challenges are with people over 18. Look at the 30-year-old male with a high school diploma. He's actually getting paid less than a 30-year-old was in 1973.

The extra wage for attending college is at an all-time high. And there's a widening gap between the pay for college graduate and graduate specialists. Gary, you've done a lot of work on how high the return on investment in higher education is, in spite of the dramatic increase in cost. But some students wonder why we have this large increase in cost. They ask, "How many hours per week are teachers devoting to school?" Is the typical professor working for 8 hours a week as a teacher and 50 hours as a consultant?

MILLER: In Illinois, legislators asked one professor, "Now, how much do you teach?" He said, "9 hours." He meant 9 hours a week, but they thought he meant 9 hours a day.

BECKER: Let's back up to the issue of the earnings differential linked to education. During the 70's you had a decline in the differential, and there were books being written about the over-educated American. That turned out to be short-lived. The increases in benefits to college are so large that they overwhelm the increasing cost.

If people are rational, you should find larger fractions of young people going to college. And that's what's happened. Every single ethnic and gender group – men, women, Hispanics, blacks – has increased the fraction of its high school graduates going on to higher education.

MILKEN: Move to the question of how we allocate capital. If the Chinese have the highest savings rates in the world, but if the savings are not generating anything for the society…

NORTH: Given the fact that political systems affect allocation, we should devote more attention to them. One of the things that has made the formal rules of the game – political

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and economic – work well in America, has been the informal norms of behavior that reinforce the formal rules.

This implies a big problem for countries that have changed the rules overnight. Russia is the classic case.

BECKER: I want to pick up the question from a different angle. I'm a believer in small government. But there are things government can do that the private sector can't do well: Enforce property rights, support basic research, support education. And governments are not performing these functions very well.

Take medical research, an area that you've been so important in promoting, Mike. The Federal Government spends something like $15 billion supporting medical research. Pharmaceutical companies spend another $15 billion, or that order of magnitude.

That's a minuscule amount. Congress is aware of the importance of medical research, but spending on other things limits its capacity to do more.

MILKEN: I don't think that if someone said we were going to go spend $20 billion, $30 billion or $40 billion in Bosnia, it would be supported easily by the public. Americans have not been asked to vote on many of these issues.

BECKER: If I go into the supermarket and buy the wrong cereal, I'm the one who suffers. But if I vote the wrong way, I really have only a tiny and indirect influence on policy.

So the political problem is that people really do not have much incentive to be well informed on issues that the Government is spending on. I don't see any way to correct that, since each of our votes basically counts for nothing in the outcome.

MILLER: I wanted to talk a bit about what can be done in Russia. I actually had the solution back in 1990, and nobody paid any attention.

I said, buy their nuclear bombs. But I was told: "Ah, but they'll produce more." I have a solution for that too: Invite all the Russian scientists to emigrate. We did that with the German rocket scientists after World War II. Then Russia can sink in its own economic problems without any concern to us.

MILKEN: Merton, a high school student can make an atomic bomb. You could never stop the supply.

AUDIENCE VOICE: Don't produce the high school students.

MILKEN: Here's another question entirely. The solution to many medical problems may lie in the 60 percent of all plants growing in the tropics. Where is the compromise between an undeveloped world looking for rapid growth and the global society that needs to preserve the rain forests?

BECKER: Mike, you raise two issues. The first is health and the second is interdependence.

I think we can do a lot better with a more efficient health responsibility program, one which would require people to buy major medical insurance and would create incentives to use health care more efficiently by letting people save what they don't spend in tax-sheltered medical savings accounts.

Now, on your second question on what to do to save plant species. The answer is to buy the rights to those plants. The developed world should be ponying up resources to induce the rain-forest countries to keep these plants. We would be offsetting their incentives to ignore the effects on other countries when they make development decisions. We would bribe them to take a broader view.

MILKEN: The point we've tried to put forth in this conference is that the decisions of economists have enormous potential to help or to hurt. At the Milken Institute we challenge leading economists not to just sit and talk but to use their ideas in the real world. It's up to all of us to judge the success of their work.

Thank you all for coming. M

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Whose interests should come first: people or places?

The question is rarely put that way, for politicians are loath to make such stark choices. Yet whether the argument is over the portability of pension benefits, tax incentives for convention centers, employment training or the elusive promise of urban inner city development, it is often at the heart of the matter.

BY GLENN YAGO

Underlying this tension is a false trade-off between economic efficiency and social equity – the notion that promotion of productivity through the mobility of resources is the enemy of economic justice.

Is the people-places debate relevant in an era of smaller government? Watch what they do, not what they say.

A dozen Federal agencies spend $6 billion annually on geographically targeted assistance. And in a kind of bureaucratic competition, state governments emulate the Feds, piling place-based programs on top of place-based programs. Indeed, if indirect tax breaks are included in the accounting, the sums spent on places by all levels of government soar into the hundreds of billions of dollars.

The issue, of course, was with us even before the time of (Robert) Moses and his all-powerful, off-budget authorities that reshaped New York. Heroic and monumental architecture ensued, and with it the shape of cities today. Location-based policies have always exerted a powerful appeal because they mobilize public resources for private interests and, in the process, sustain political power – a long way of saying that location-based policies fill the pork barrel. By contrast, policies that enable citizens to vote with their feet – to move from one jurisdiction to another – undermine the power of the political establishment.

This tension came to light long before Ronald Reagan declared war on The Great Society. Jefferson scrapped Hamilton's plan for a major national government role in promoting economic development. Andrew Jackson followed suit, identifying government as the source and protector of economic privilege. The Jacksonians dismantled the Second Bank of the United States, slashed tariffs and privatized government transportation. Similar conflict arose in reaction to the Progressive era.

Programs designed to benefit localities rarely add up to much. There are few examples of regional development that create jobs, as opposed to moving them from locality to another. In attempting to respond to market failures – for example, chronic regional unemployment – government compounds the failures by building the wrong factory in the wrong place. If planning doesn't work in

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Russia or Indonesia, there's no particular reason to believe it will work in America.

To understand the advantages of people-based programs, consider Joseph Schumpeter's analogy between the distribution of income and the registration at a hotel. The accommodations vary from shabby closets on the airshaft to penthouse suites with grand views. But to the degree that people have a good chance to move to better rooms next month or next year, one doesn't feel compelled to redecorate.

By analogy, geographic mobility has often proved a potent substitute for conventionally defined economic mobility. Public education and support of interstate transportation are just two examples of successful government policies that enhanced equity even as they promoted growth.

Yet from Johnson's Model Cities program to current experiments with Urban Enterprise Zones, urban policy has been almost exclusively place-based. Since the Watts Riots, the vicious cycle characterized by unemployment, crime and a lack of public services has persisted. Neighborhoods swallowed urban development dollars with hardly a trace, even as people and private wealth took flight.

The intransigence of urban problems contrasts with more promising people-based developments. Today, the earnings of blacks have nearly caught up with those of whites with similar education. The proportion of young adults who complete high school is now the same for blacks and whites. There are more than 2 million minority companies with $250 billion in sales – 25,000 of them with revenues exceeding $1 million.

Since 1987 the number of minority companies has grown 10 percent annually versus 4.7 percent for non-minority companies, while sales have grown 21 percent annually versus 10.7 percent. Skill-intensive areas such as finance, insurance and business services have been the fastest growing kinds of minority enterprises.

By contrast, the denouement of place-based programs have been painfully consistent. Model Cities failed because it emphasized bricks and mortar and ignored human capital. Nixon-era programs that pressed Fortune 500 companies to create inner city subsidiaries failed when those enterprises were eclipsed by foreign competition. Location-based programs since then have also failed where they focused on services for inner city markets and never developed links to the outside world. Finally, the failure to leverage government investment with private sector money has often inhibited minority business development by restricting entry into mainstream markets.

What works for minority business development works for home ownership. Since 1994, 43 percent of all new homeowners have been minority families. Success in this market was based on efficiencies achieved in the lending process: standardized applications, credit scoring, underwriting and secondary market developments. It is highly unlikely that costly subsidies would have had more impact than low-cost, market-based incentives such as the government-guaranteed secondary market for mortgages.

It is no surprise that nuts-and-bolts development programs to support individuals work better than those that support bureaucracies. The real surprise is that otherwise sensible people haven't seen the light. America's great advantage over other mature industrial economies lies in the ability of its markets to move people and capital to where they are most productive. Where markets have failed us, the answer is to make them work – not to transfer the power to allocate resources to government. M

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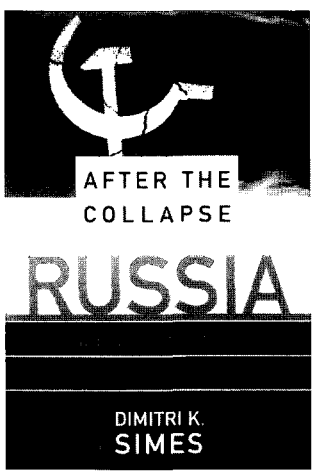
"Dimitri, it's all over." It's really over," said Richard Nixon – referring not to his checkered career but to the erstwhile Soviet Union. So opens Dimitri Simes' alternately incisive and silly memoir-like book.



After the Collapse: Russia Seeks Its Place as a Great Power.

By Dimitri K. Simes

Simon and Schuster, 272 pp. Cloth $25.

Reviewed by Stephen Kotkin

First, the silly stuff. Simes, a Russian émigré who is now president of the Nixon Center in Washington, accompanied Watergate's unindicted co-conspirator to the Soviet Union in 1991 for meetings with academics as well as the soon-to-be-obsolete Mikhail Gorbachev. The 78-year-old Nixon, it seems, could recognize a doomed politician instantly.

Calling Gorbachev "a poor bastard who belongs to the past," the former American president is said to have been involved in "masterminding a strategy to influence American foreign policy" 17 years after having been forced to resign. For Simes, being a part of Nixon's "design" was "a great treat." Nixon, too, was "loving every second of it." Gorbachev was presumably having less fun, but he comes across as a secondary character: The book's index contains only 12 lines of entries for the Soviet president, while citizen Nixon manages 13.

Simes feels compelled to interject that "this is not a book about Richard Nixon." Even so, his worldview is decidedly Nixo-centric.

The fourth chapter, entitled "Russia is Reborn," begins with an assertion that most everyone got the new Russia wrong – except Nixon, who was even able to understand "the main thrust" of conversations in Russian without a knowledge of the language. Here, we discover that the Soviet K.G.B. chief tried to draw Nixon into his plot against Gorbachev. We learn, too, that Nixon helped the up-and-coming Boris Yeltsin to be taken seriously in Washington, admonishing Simes to keep mum about Yeltsin's unsteadiness and alcoholism since "the man is obviously under tremendous pressure."

The fourth chapter contains many other interesting tidbits, just nothing on Russia's

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rebirth. In subsequent chapters we get accounts of Nixon's final visit to Moscow, Nixon's critique of Bush, Nixon's critique of Clinton, Nixon's words of advice to Soviet (and later, Russian) policy makers. For events that take place after Nixon's death, Simes speculates on how Nixon would have reacted.

Simes, for his own part, assumes the mantle of semi-dissident. His qualifications are threefold: 1) he is Jewish, 2) before he emigrated in 1973, his mother, a defense counsel to actual dissidents, was frequently mentioned on Russian-language broadcasts of Radio Liberty and Voice of America, and 3) in 1966 the young Dimitri tried to organize a student meeting "to denounce" Soviet involvement in Vietnam, for which he was expelled (briefly) from Moscow University. Outright opposition, he writes, "was heroic but futile."

Whatever the problem, it did not prove fatal to his career.

Simes quickly resumed his studies, and soon landed a plum research position at the Soviet Union's most prestigious foreign policy think tank, the Institute of World Economy and International Relations. Even though, as Simes writes, the appointment was arranged by his father-in-law, it was not the kind of post given to enemies of the state. The institute was extraordinarily close to the Communist Party Central Committee. Moreover, Simes discloses that he served as first secretary of the institute's branch of the Communist Youth league.

Simes's boss at the institute was Yevgeny Primakov, now Russia's Prime Minister. For a Soviet apparatchik, even one in the scholarly world, the emigration of an underling did not always carry momentous consequences, but it could not have been pleasant. Simes claims that Primakov initiated a self-protective whispering campaign, accusing the defector of having faithfully served the system and of having been a nobody – "almost a member of the cleaning staff."

Simes responded by writing to Primakov from abroad. Calculating correctly that the K.G.B. would read the letter, Simes wrote not to complain about Primakov's barbed gossip but to remind him of their long-standing close association. The maneuver, Simes writes, was intended to demonstrate that two could "play" at the game of inflicting harm by means of innuendo.

This reviewer is convinced. As for the substance of Primakov's alleged badmouthing, Simes reveals that he did compose officially approved op-ed pieces at the institute, while giving lectures on the side "for a nice fee." He confesses here, however, that it bothered him that he could not write "honestly."

Readers may wonder how a former Communist Youth leader and critic of America came to serve an American politician whose ascent had been predicated on anti-Communism. Simes explains that he received an invitation from Nixon to meet in 1985, after having written an op-ed piece "reappraising" him as "a very impressive President" and "an honorable statesman."

"This book could not have been written without Richard Nixon," Simes acknowledges. But the expression of gratitude extends well beyond the acknowledgements. We are also informed that Nixon found Simes a wife, served as best man at their wedding and personally selected him to head the Nixon Center.

When Simes drops names, he makes sure to record Nixon's presence. If the ex-President was absent, Simes hastened to brief him afterwards. He diligently reports on the compliments Nixon bestowed, but also describes one meeting with Russian officials in which Nixon deliberately failed to make known his agreement with something Simes had written and

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"enjoyed seeing me put on the defensive."

Some aspects of Simes's work over the years do not find a place in the book. When Gorbachev was named General Secretary in March 1985, for example, Simes, then a senior Sovietologist at the Carnegie Endowment for International Peace, told *The Christian Science Monitor* that the new Soviet leader "has no new ideas." Simes does write in the book that upon traveling to Moscow in Oct. 1987, and sitting next to one of Gorbachev's closest advisors at a White House state dinner the following December, he belatedly grasped the seriousness of Soviet reforms.

This could be true. But Simes fails to mention here that a year later, he was still vehemently dismissing Gorbachev's radical and unprecedented arms-reduction proposals as dangerously Machiavellian. Nixon was also arguing at the time in *Foreign Affairs* magazine that "under Gorbachev, the Soviet Union's foreign policy... has been more aggressive, not less" – an absurdity that Simes chooses not to quote.

By the time Simes and Nixon got around to revising their publicly stated views on the consequences of Gorbachev's new thinking, the latter's Presidency was all but over. With hindsight, Simes observes that the Soviet political system and empire were "betrayed" by the ruling elite. "It was widely assumed," he writes in apparent reference to himself, that the fully armed Soviet regime had "the resources... and the will to retrench" if attempted reforms went too far. "No one anticipated that a leader would come to power who knew the rules of the Communist party *apparat* and could use them with tactical genius... while simultaneously not understanding the fundamentals of the system."

Arguing that Gorbachev unwittingly destroyed the Soviet system, Simes plays down the importance of external threats, such as Reagan's military buildup and the "Star Wars" missile defense initiative. By implication, Nixon cannot be accused of appeasement or of prolonging the Soviet Union's existence with his policy of détente.

Now for the incisive part. "After the collapse," Simes writes, some two hundred pages into the book, "Russia was left without a clear conception of its national interests." He shows that Russia's quest for "its place as a great power" remains unresolved, but that after a shaky start Russia has begun to articulate and defend its state interests.

Since 1996, Primakov, first as foreign minister and then as prime minister, ended Russia's subservience to Washington. Simes argues that, under his old institute boss, Russia has come to accept that it is no longer a superpower and that nostalgia is not a guide for effective diplomacy. It makes a point of standing up to the United States, but stops short of outright confrontation. Its diplomacy is based not on a global ideology but on domestic needs – particularly economic interests, such as the pending Caspian Basin energy bonanza.

Accordingly, Simes sensibly advises the United States to build lasting ties founded on mutual interests and mutual respect, instead of seeking to remake Russia in its image. "The Russians may resent American predominance," he observes, but "chances are that almost anyone who should come to power in Russia... will be interested in normal relations with the United States," provided the United States avoids gratuitous grandstanding about Russia's irrelevance.

Simes underscores this realpolitik approach by quoting Russia's former ambassador to Washington, Vladimir Lukin: "Just name us a 'great power,' for God's sake – then you can do whatever you like."

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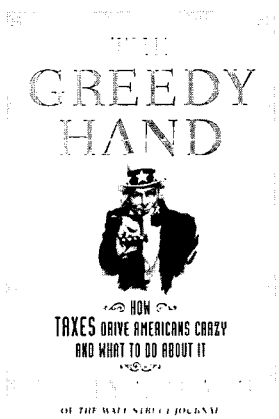
AMITY SHLAES is a member of *The Wall Street Journal*'s editorial board, where she often writes on tax policy. And the *Journal*'s editorial cure-all, you probably know – the secret to undreamed-of prosperity in the future – is to lower the taxes paid by higher-income folks. Thus when the book arrived, I immediately flipped to the concluding chapter, hackles up.



The Greedy Hand: How Taxes Drive Americans Crazy and What to Do About It

By Amity Shlaes

Random House, 240 pages. $22.95

Reviewed by Joel Slemrod

It was not what I expected. Shlaes lays out some principles she believes should guide tax reform, most of which I find pretty hard to argue with. Taxes should be simple. Taxes are, first and last, a source of revenue: no trying to save the world (or the middle class) through the tax code. And to her credit, Shlaes takes on not only the easy targets, but also some tougher ones, such as the deduction for home mortgage interest.

Next, taxes ought to be lower. Other things equal, this one's a no-brainer. But other things (specifically, revenue) aren't equal. And exactly which programs ought to be cut to cover the shortfall aren't covered in book. I, too, favor, eliminating programs that are not worth their cost. This is not really a tax reform question, though, but rather a matter of the proper size and scope of government.

To this point I almost felt the author and I were comrades in arms. But what exactly should be done about taxes? The easy part is to point out inconsistencies and even outrages – the "what drives Americans crazy" of the book's subtitle. The hard part is to identify the appropriate path to reform – the "what to do about it" of the subtitle. And here, *The Greedy Hand* disappoints.

The book devotes just three pages to specifics. It dismisses a national retail sales tax or value-added tax on the grounds that either approach would make us a nation of scofflaws. End of argument.

The Greedy Hand spends all of one paragraph on the most intriguing tax idea of the last two decades – the Hall-Rabushka "flat tax" championed by the House majority leader, Dick Armey, and the Republican presidential candidate Steve Forbes – dismissing it as "a radical measure, particularly when it comes to business taxes." As if that weren't bad enough, the flat tax "would involve disruption." So much for the fire-breathing Republican idea of tearing the income tax out by its roots.

Shlaes does seem to favor a third, "serviceable" option: "clear out the underbrush and put through lower, simpler rates that apply to all in a consistent manner." If you think this sounds like the spirit behind the sweeping Tax Reform Act of 1986, you wouldn't be off base. Earlier in the book, Shlaes refers to that act as "the only solid tax reform in recent years." But if you think Shlaes is casting her lot with

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liberal reformers like the late Joe Pechman, tax sage of the Brookings Institution, you'd be wrong.

Another of Shlaes' guiding principles is that "we don't have to load extra taxes on the rich." Good liberal Pechman probably wouldn't have put it quite this way. But even this principle is hard to oppose until it's clear what "extra" means.

Shlaes does allude approvingly to one particular proposal, the "alternative maximum tax," calling it ingenious. Under the plan, would taxpayers have a choice between forking over what they would owe under the current system or simply paying a fixed portion of their income – say, 20 to 25 percent – to Uncle Sam.

Finally, she gives us something concrete to shoot at – and an inviting target, no less. For the alternative maximum tax would preserve all the complexity of the existing system, adding a new layer that would create unimaginable (except to good tax lawyers) opportunities for: a) playing one system against the other within a tax year, b) playing one year against the next, c) playing off the tax liabilities of related individuals using different options. And don't forget the small matter of how to make up for the loss of tens of billions in revenues.

The bulk of the book goes about the easier task of demonstrating that the current tax system is too complex, too intrusive and too often economically distorting. Come to think of it, it isn't all that easy to demonstrate this and keep things from getting dull. *The Greedy Hand* involves the reader, making ought-to-be-dry analysis come alive with anecdotes. The main sections are loosely organized around stages of life: "Your Work," "Your House," "Your Accountant," "Your Baby," "Your Death."

The chapter on marriage is especially effective, laying out the impossibility in a progressive tax system of eliminating the marriage penalty without creating a "stay-at-home-mom" tax. It also illustrates very neatly how the current tax system has become entangled in the culture wars, a weapon in the battle over the role of women and the sanctity of marriage.

Many of Shlaes's anecdotes, including the details of the introduction of income tax withholding in 1943, are new even to old tax hands like me. Others make the I.R.S. look heartless. Exhibit 1: The I.R.S.'s pursuit of relatives of victims of the Lockerbie airplane crash, demanding taxes in advance on the multimillion dollar settlements that the I.R.S. estimated they would receive from Pan Am's insurers.

Of course, the anecdotes not recounted here are also revealing. For example, outrage at the I.R.S. could have been channeled elsewhere if the book had focused on tax evasion scams that effectively increase the tax burden on the non-scammers among us. In other cases cited by Shlaes, it is more difficult to cast the taxpayer as victim, as in the long account of how the income tax complicates the lives of families who are looking to hire good nannies. This issue inspires Shlaes to somewhat misplaced revolutionary fervor. "As long as high taxes cut at families' freedom," she writes, "the struggle will continue."

Nevertheless, after reading ten chapters of *The Greedy Hand*'s breezy prose, it is hard to dispute that the tax structure is "an unwieldy artifact of an irrelevant era" and that Thomas Paine was prescient when he spoke of "the greedy hand of government, thrusting itself into every corner and crevice of industry."

But anecdotes are not enough. While they can certainly illustrate the intrusiveness, inconsistency and downright silliness of the

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current structure, they're no substitute for tight analysis of difficult issues.

Consider the question of tax progressivity. Although Shlaes waffles on exactly what sort of tax system she favors, she is crystal-clear in opposing what she calls the core principle of the existing code. Any progressivity at all – even a single rate tax with an exempt level of income – would fail *The Greedy Hand* test.

There are certainly intellectually respectable economic grounds for opposing progressivity. The trade-off between fairness and efficiency in tax design has been a – maybe the – contentious issue in public finance over the last century. But Shlaes doesn't deign to dip a toe into the huge pool of research assessing the distortions created by progressive taxes. Instead, she argues that progressivity is, in the words of the French pamphleteer Frederic Bastiat, a "fatal illusion," meaning that no matter how we attempt to tax them, the rich manage to evade the bite and thus "the wrong people end up paying."

Shlaes seems to argue not that progressivity is too costly, but that it is not feasible. To be sure, the two criticisms are related since the time and money that the affluent devote to tax avoidance are, from society's point of view, an irredeemable loss. But the two arguments are distinct and have drastically different implications about where to look for reforms.

If the problem is making the income tax progressive in reality as well as in name, we should be looking at structural defects in the system, such as the preferential treatment of capital gains. But this is not the road Shlaes, as a member in good standing of *The Wall Street Journal* editorial board, recommends. She wants to scrap progressivity because it is leads to big, intrusive government and throttles the growth potential of the economy.

Surprisingly, the effects of high taxes on growth are given little attention. Shlaes does assert that progressivity stops people from starting new businesses and such. And, without much elaboration, she tosses in the argument that lower tax rates on the rich generate more revenue, not less. But she does not seem to have much enthusiasm for this line of attack.

Perhaps she wanted to spare her readers the joy of plowing through a discussion of labor supply elasticities and tests of statistical significance. Perhaps she sensed this argument would not resonate during a boom that followed on the heels of tax rate increases in 1990 and 1993. Or perhaps she wished to avoid a discussion of the fact that the halcyon years of United States economic growth, the 1950's and 1960's, featured top marginal tax rates above 90 percent.

Whatever the reason, *The Greedy Hand* is not the place to look for help in sorting out the costs of alternative tax systems. My own reading of this evidence suggests that it would certainly be possible to raise more revenue from the affluent – and that the waste created in doing so would be significant, but lower than might be expected if the tax base hadn't been broadened since 1986.

The Greedy Hand devotes one chapter each to Social Security (her solution: privatize it) and to financing public schools (her solution: localize it). I was struck here by the inverse relationship between the attention Schlaes gave to a topic and the radical nature of the proposed fix.

Obviously, Amity Shlaes has thought long and hard about what ails the tax system, and her book is an engaging, eye-opening account of the symptoms. But, as a guide to action it is surprisingly unfocused, perhaps because there are no easy answers. I will be pleased, though, if *The Greedy Hand* enlists a few more people in the cause of simplifying and rationalizing the United States tax system. M

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STEP RIGHT UP, FOLKS! SEE THE GOOSE THAT LAYS THE GOLDEN EGGS!
STOCK MARKET INDEX FUNDS WILL GIVE US ALL THE GOLD WE NEED!
S&P 500
JUST FEED IT HEFTY PORTIONS OF OUR SOCIAL SECURITY TRUST FUND AND VOILÁ!
NOT QUITE, FOLKS! NOT QUITE!
DON'T LET GOVERNMENT BAMBOOZLE YOU OUT OF YOUR HARD-EARNED MONEY! INVEST IT YOURSELF IN THE GOOSE OF YOUR CHOICE WITH NO MEDDLING MIDDLEMAN!
GOP
BUT WHAT IF OUR PRIVATE INVESTMENTS FAIL? WHO'LL LOOK OUT FOR US THEN?
OUTA MY WAY, LITTLE MAN! YA' BOTHER ME!
BUT LIFE EXPECTANCY WAS 61 WHEN THEY SET ELIGIBILITY AT 65. NOW LIFE EXPECTANCY IS 76. SIMPLE LOGIC WOULD DICTATE...
WE'RE NOT A DICTATORSHIP! WE'RE A LAND OF OPPORTUNITY!
BUT IF WE RAISED THE TAX AND THE ELIGIBILITY AGE...
NO NEED, FOLKS! YOU SEE THESE EGGS?! SOLID GOLD!
19%
23%
GOP
I PROMISE YOU, FOLKS! BET THE FUND ON THE GOLDEN GOOSE AND, GUARANTEED, ONE WAY OR ANOTHER, IT WILL...
LAY AN EGG?

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